

CBO

Options for Taxing U.S. Multinational Corporations

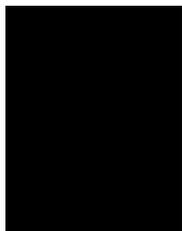
The collage features several international tax forms and documents:

- Skatteverket (Denmark):** A form with the text "Senast den 3 maj hos Skatteverket" and "Namn (firm) address".
- Ontario (Canada):** A form with the text "Return Address" and "Office of the Revenue Commissioners, Collector-General's Division, PO Box 354, Limerick." It also includes the text "RETURN OF PROFITS, CHARGEABLE GAINS, THE ACCOUNTING PERIOD INDICATED HERE" and "State Company Accounting Period (DD/MM/YYYY)".
- HM Revenue & Customs (UK):** A form with the text "Your company tax return" and "Company information".
- Republika de Chile (Chile):** A form titled "REPUBLICA DE CHILE SERVICIO DE IMPUESTOS INTERNOS" with a table of "TIPOS DE RENTAS Y REBAJAS" (Types of Income and Deductions) including items like "Retiros", "Dividendos", "Gastos rechazados", etc.
- Mauritius:** A form titled "INDIAN INCOME TAX RETURN" with the text "Please quote your TAX ACCOUNT No. in all communications addressed to the Mauritius Authority, Ehram Court, Cnr Mgr Gonin & Sir Virgil Naz Streets, Port Louis." and "PARTICIPATION DES SA".
- U.S. Department of the Treasury:** Form 1120, "U.S. Corporation Income Tax Return", for calendar year 2011 or tax year beginning in 2011, ending in 2011. It includes sections for "Check if:", "TYPE OR PRINT", and a table for line items 1a through 1d.

Notes

Unless otherwise indicated, the years referred to in this report are federal fiscal years, which run from October 1 to September 30.

Numbers in the text and in tables may not add up to totals because of rounding.



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Options for Taxing U.S. Multinational Corporations

Summary

In 2008, 12 percent of all federal revenues came from corporate income taxes; about half was paid by multinational corporations reporting income from foreign countries.¹ How the federal government taxes U.S. multinational corporations has consequences for the U.S. economy overall as well as for the federal budget. Tax policies influence businesses' choices about how and where to invest, particularly as corporations assess whether it is more profitable to locate business operations in the United States or abroad. The tax laws also can create opportunities for tax avoidance by allowing multinational corporations to use accounting or other legal strategies to report income and expenses for their U.S. and foreign operations in ways that reduce their overall tax liability. U.S. tax revenues decline when firms move investments abroad or when they strategically allocate income and expenses to avoid paying taxes here.

A country can take two general approaches to taxing the income of corporations that operate both domestically and abroad:

- Under a *worldwide* approach, the home country considers all of the income of its multinational corporations to be taxable, regardless of where that income is earned. But to avoid taxing income twice—in the home country and in the country where it is earned—a country would generally allow multinational corporations to claim a *foreign tax credit* against domestic tax liability for taxes paid elsewhere.

- Under a *territorial* approach, the home country taxes only the income earned within its borders.

No major developed country has adopted either approach entirely. Although many developed countries use a more territorial approach, the system in the United States leans toward a worldwide approach, but one that allows multinational corporations to defer or, in some cases, completely avoid paying U.S. taxes on some income they earn abroad.

This study examines policy options that could move the United States closer to one system or the other, along with several approaches to addressing particular concerns about the current system of taxation. All would affect multinational corporations' investment strategies and reporting of income as well as U.S. revenues from corporate income taxes.

Current Federal Tax Treatment of U.S. Multinational Corporations

The U.S. government taxes both the domestic and the foreign income of businesses that are incorporated in the United States and that operate abroad. Often, such corporations also must pay income taxes to their foreign host countries. At the national level, the top corporate tax rate in the United States (the statutory tax rate on income in the highest bracket) is 35 percent. When combined with state and local corporate taxes, that rate rises to 39 percent—higher than that in any of the other 34 member countries of the Organisation for Economic Co-operation and Development (OECD). Weighted by gross domestic product (GDP), the average statutory rate among OECD countries in 2011, excluding the United States, was about 29 percent.* [*Calculated rate corrected on February 26, 2013]

1. That year is the most recent for which detailed data are available. Since then, receipts from corporate income taxes have accounted for a smaller share of federal revenues—ranging from 7 percent in 2009 to 10 percent in 2012.

Although the U.S. system is generally more worldwide than territorial, two important features of its tax system depart from the worldwide approach. First, a purely worldwide tax system would ensure that firms faced the same tax rate no matter where they operated. If the United States were to have such a system, it would not limit the credit granted to firms for the total taxes paid abroad, regardless of whether those taxes exceeded the domestic liability on the income. Under the U.S. system, however, the largest credit a corporation may take is one that matches the amount the firm would pay in U.S. taxes on the same income. Thus, U.S. corporations that operate in countries that tax at a higher rate than the United States does must pay the foreign tax rate on that income. Second, companies can defer U.S. taxes on income earned abroad by their subsidiaries until that income is remitted (or “repatriated”) to the U.S. parent company, thus allowing some foreign income to escape U.S. taxation—at least temporarily.

Those features of the U.S. tax system affect U.S. multinationals’ decisions about whether and how to invest at home and abroad. The current tax system provides incentives for U.S. firms to locate their production facilities in countries with low taxes as a way to reduce their tax liability at home. Those responses to the tax system reduce economic efficiency because the firms are not allocating resources to their most productive use. Those responses also reduce the income of shareholders and employees in the United States and they lead to a loss of federal tax revenue. In addition, those investment decisions may initially result in more unemployment in this country. Over time, however, as the economy adjusts, other jobs are created and total employment would not be significantly affected. But as a result of such decisions, in the long run, total compensation for U.S. workers is lower, and employment may be concentrated in different industries and regions.

The current system also creates incentives to shift reported income to low-tax countries without changing actual investment decisions. Such profit shifting erodes the corporate tax base and leads to wasted resources for tax planning.

Policy Options

The options presented in this report are targeted at several areas of concern about the effects of the U.S. tax system on the flow of investment outside the United States and the reporting of U.S. corporate profits. Some

options are broad, designed generally to address the flows of U.S. investment to other countries. Other options are narrower, addressing tax avoidance by U.S. firms that strategically allocate reported income and expenses between their U.S. and foreign operations. Some options would result in a more efficient allocation of resources among countries and also would impede the ability of corporations to avoid paying U.S. taxes; others would achieve just one of those two goals and could in fact make it more difficult to achieve the other.

A Worldwide System. Options that would move the United States closer to a purely worldwide tax system—by eliminating or curtailing deferral of U.S. taxes on income earned abroad—would dampen incentives to shift investment or reported income on the basis of concerns about tax liability. As a result, those options would generally lead to more economically efficient business investment and increase corporate tax revenues from firms that remained incorporated in the United States. But moving closer to a purely worldwide system also would strengthen the incentive for U.S. firms to incorporate, or register, abroad or to be acquired by or merge with foreign companies. Such a response probably would not increase the efficiency of investment decisions, and it would reduce the corporate tax base. On balance, however, eliminating deferral would boost both efficiency and tax revenues. In fact, eliminating deferral entirely would boost U.S. tax revenues by more than \$100 billion over a 10-year period, according to an estimate by the staff of the Joint Committee on Taxation (JCT); that would be the largest revenue increase attributable to any of the options discussed in this report.

A Territorial System. Alternatively, the United States could move toward a territorial system—for example, by exempting some income earned abroad from U.S. taxation or by taxing domestic income only but using a formula that considered the location of a company’s activities to determine the sources of its income. Such policies could result in a less efficient allocation of resources among countries by increasing incentives to shift business operations and reported income to countries with lower tax rates. Nonetheless, some options for moving toward a territorial tax would increase U.S. tax revenues by restricting the ability of multinationals to shield some income from U.S. taxation and by preventing them from deducting costs incurred abroad from income earned in the United States.

Other Options. Some options would restrict corporations' ability to use excess foreign tax credits, which are generated by income earned in countries where taxes are higher than they are in the United States. Under current law, a business can use those credits to offset U.S. taxes on income that is repatriated from low-tax countries, effectively decreasing the U.S. taxes they pay on foreign income and increasing their incentive to invest abroad. Thus, restricting the use of excess credits could increase federal tax revenues and reduce the incentive to invest abroad. Such a restriction, however, might push some firms to take greater advantage of provisions that allow deferral of taxes on income that is earned—and retained—abroad. The net effects of such a restriction on investment and repatriation of income are unclear, but it could increase U.S. tax revenues.

Other options would produce more incremental changes, generally limiting opportunities for corporations to shift reported income abroad and thus increasing the amount they must pay in U.S. taxes. Those options would treat entities and recognize income in a more consistent way across jurisdictions. One disadvantage is that such options also would strengthen incentives for shifting investments instead of just shifting reported income. However, such options are fairly narrow, and the overall effect on the location of businesses' investments would probably be small.

Two Basic Approaches to Taxing Multinational Corporations

Multinational corporations are businesses that incorporate and operate in one country (in this report called the home country) but that also maintain operations of various kinds in other countries (called host countries). Multinational corporations operate abroad for many reasons, including favorable tax laws, but they also do so to gain access to foreign markets, to employ a less costly labor force, and to obtain materials that are less expensive than those available at home.

There are two basic approaches to taxing the income of multinational corporations: the *worldwide approach* and the *territorial approach*. Under the first system, multinational corporations are taxed by the home country on their worldwide income without regard to where it is earned. Countries that adopt such an approach generally also provide for credits or deductions for taxes paid to host countries. At the other end of the spectrum, under

the territorial approach, the home country taxes only the income that is earned within its borders, and it imposes no tax liability for any income earned abroad.

Each approach has different implications for the tax rates multinational firms face on income earned in foreign countries. If a country adopted a worldwide tax system with no limits on the size of its foreign tax credit (even if the foreign taxes exceeded domestic tax liability on the income), then all corporations' income—whether earned at home or from investments abroad—would be taxed at the home country's rate.

Under a territorial system, by contrast, multinational corporations' tax liability would depend on the rate set by the host country, and the only way to ensure that all of a country's multinational corporations faced the same tax rate—regardless of the source of their income—would be to have a universal, territorial tax system under which all countries treated multinational firms the same way—that is, having the same tax base and rate structure.

How a home country taxes foreign-earned income can affect businesses in a significant way: Because many other countries in which such firms operate also tax income earned within their borders, business managers must decide whether investing abroad would be worthwhile, given the prospect of paying additional U.S. taxes on that same income.

Different countries take different approaches to and have different systems for taxing income earned abroad. No major developed country has adopted either a completely worldwide or a completely territorial tax system. Instead, many have developed what are essentially hybrid systems that incorporate significant aspects of both approaches.

The U.S. tax system leans toward a worldwide approach; it imposes taxes on multinational corporations' foreign income but allows those businesses to claim deductions or credits for the taxes they pay abroad. Multinational corporations also can defer or, in some cases, completely avoid paying U.S. taxes on some income earned abroad. Deferral and some other mechanisms make the U.S. system territorial in some respects.

In contrast, most member countries of the Organisation for Economic Co-operation and Development take a largely territorial approach by exempting certain foreign-earned income from taxation (by means of what is often called an exemption system). Some of those

Table 1.

Progressive Structure of U.S. Corporate Income Tax Rates, 2012

(Percent)

Income Range (Dollars)		Statutory Corporate Tax Rate	Excess Tax	Total Rate
Over	But Not Over			
0	50,000	15	0	15
50,000	75,000	25	0	25
75,000	100,000	34	0	34
100,000	335,000	34	5 ^a	39
335,000	10,000,000	34	0	34
10,000,000	15,000,000	35	0	35
15,000,000	18,333,333	35	3 ^b	38
18,333,333	—	35	0	35

Source: Internal Revenue Service.

- The excess tax offsets the benefit of rates below 34 percent for income in the range between zero and \$75,000.
- The excess tax offsets the benefit of rates below 35 percent for income below \$10 million.

countries also have “anti-abuse” rules that govern the type and source of foreign income that can be exempted from taxation, reducing the ability of firms to take unfair advantage of a territorial tax system by shifting the location of income.² France, for example, disallows exemptions for income earned in countries whose corporate income tax rates are at least 50 percent below its own. Germany taxes income earned in any foreign country where the tax rate is less than 25 percent, and it taxes all foreign income from certain types of business activities. Under Italy’s anti-abuse rules, a “blacklist” prevents income earned by Italian multinational corporations in some countries from receiving an exemption from taxation at home. Strong anti-abuse rules can result in systems that effectively tax foreign income in a way that is much closer to a worldwide approach.

Federal Tax Treatment of U.S. Multinational Corporations

The amount of taxes that U.S. multinational corporations pay depends on several factors. As is the case for

2. Such rules are sometimes called CFC rules because they apply to income from controlled foreign corporations. For a comparison of various national tax systems, see Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income*, JCX-33-11 (May 20, 2011), <http://go.usa.gov/gPrJ>.

domestic corporations, multinationals are assessed corporate income taxes on earnings that exceed their expenses. Although those expenses can include taxes, current law generally provides for a system of credits for taxes paid to foreign governments that allows those companies some relief from what would amount to double taxation of that income.

The U.S. system allows multinational corporations to combine credits for taxes paid to more than one foreign country; in 2008, those credits amounted to about \$100 billion. Moreover, payment of U.S. taxes on foreign income can be deferred until the income is repatriated to the United States. Because of such deferral, the corporation’s total tax liability is effectively reduced if the taxes paid to another country are less than the amount the United States would levy on the same income.

The Federal Corporate Income Tax

The U.S. corporate tax system defines income broadly to include revenues from sales, interest, dividends, capital gains, royalties, and rents. To compute taxable income, corporations subtract business expenses (including the costs of goods sold, depreciation, advertising expenses, and interest payments) from their total income. Although corporations are allowed to deduct the interest they pay to bondholders, they cannot deduct dividends paid to shareholders; such dividends are subject to the individual income tax as well.

In general, corporations’ federal income tax liability is computed according to a progressive structure starting at 15 percent for the first \$50,000 of taxable income and rising to 35 percent on income above \$10 million (see Table 1). Income between \$100,000 and \$335,000 is subject to an additional tax of 5 percent (raising the effective rate from 34 percent to 39 percent), and an additional 3 percent tax is assessed on income between \$15 million and \$18.3 million (raising the effective rate from 35 percent to 38 percent). For corporations with income in those ranges, such “excess taxes” effectively offset the benefit of the three lower tax rates. Although the excess taxes yield a higher tax rate over some income ranges, most corporations’ income is taxed at the 35 percent rate (the statutory rate that applies to income in the highest tax bracket).

It is often noted that the top rate set by U.S. law—35 percent (or 39 percent, on average, once state and local corporate taxes are included)—is among the highest for developed countries. However, other features of the

U.S. tax code, such as credits and preferential rates, effectively lower the tax rates. (The appendix describes U.S. corporate tax rates and compares them with those of other countries.)

U.S. Rules for Taxation of Income Earned Abroad

Two important features affect the U.S. tax treatment of foreign income. First, the foreign tax credit is limited to the amount of U.S. taxes a corporation would pay here on its income from foreign sources; a corporation may not take a credit on its foreign income that is larger, in the aggregate, than its U.S. tax liability is for that income. Second, payment of U.S. taxes on income earned—and kept—abroad can be deferred until the income is returned to a U.S. parent corporation. That feature adds a territorial aspect to the U.S. tax system in that foreign income receives preferential treatment. Other provisions and regulations (discussed later in this report) also contribute to a partially territorial approach.³

Under the U.S. system, taxation of foreign income is affected by a corporation's structure. In some cases, multinationals operate abroad through branches that act as extensions of their U.S. parent companies; their foreign-earned income is considered the legal income of the U.S. parent company and thus is taxed as it is earned. In other cases, corporations establish subsidiaries that incorporate as separate entities abroad. For those businesses, the parent corporation owns shares in the subsidiary and receives income in the form of dividends, which are not subject to U.S. taxation until the money is returned to the U.S. parent. A common type of subsidiary, the controlled foreign corporation (CFC), is incorporated abroad and has a majority of its stock owned by U.S. shareholders.⁴

Limits on Foreign Tax Credits. When the corporate income tax was established in 1909, lawmakers allowed businesses to claim a deduction for taxes paid on income earned abroad. A tax deduction, however, only offsets a share of foreign taxes.⁵ That tax deduction was later converted to a tax credit, with no limits on the amount received, ensuring that income from foreign operations would not be taxed twice. With an unlimited credit,

businesses that operated in countries where tax rates were higher than those of the United States received a tax credit that exceeded the U.S. tax on their foreign income and thus could use the excess credit to offset the U.S. tax on their domestic income. By comparison, businesses operating in low-tax countries paid the full U.S. tax on their domestic income. An unconstrained credit also provided an implicit U.S. subsidy of foreign governments: A portion of the taxes paid to those governments was in effect paid by the U.S. government in the form of foregone revenues. In response to those concerns, in 1921, lawmakers capped the foreign tax credit.

Under current law, the credit cannot exceed the amount of taxes that a company would pay under the U.S. tax code. That limit ensures that the United States does not subsidize other countries by extending credits in excess of what it collects in taxes. As an example, suppose a multinational corporation earns \$100 million in before-tax income in its domestic operations in the United States and an equal amount, currently subject to U.S. taxes, from the operation of its subsidiaries in other countries (see Table 2). Under U.S. tax law, the combined income is subject to a 35 percent rate—and the firm owes \$70 million in corporate income taxes (before allowing for credits). Suppose the other countries tax corporate income earned within their borders at a rate of 40 percent. The firm therefore would pay \$40 million in taxes to the foreign countries (40 percent on the \$100 million earned there). Under U.S. law, the firm can then claim a credit up to the amount it owes the United States on the same income—in this case, \$35 million (35 percent of the \$100 million). In this example, the firm pays \$75 million in taxes—\$35 million to the United States (after taking the credit) and \$40 million to the other countries—\$5 million more than it would if there was no limit on the amount of the credit.

The credit that can be taken for paying foreign taxes has changed. Initially, there was an overall limit (as in the simple example above). From 1932 to 1976, the foreign tax credit was calculated separately for each country as a

3. See Edward Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes* (September 5, 2011), pp. 1021–1042.

4. Although each U.S. shareholder of a given CFC must own at least 10 percent of the stock, it is common for 100 percent of the stock in a CFC to be owned by a U.S. corporation.

5. A deduction is an expense or an amount of money that reduces a taxpayer's taxable income, thus reducing the tax liability by the amount of the deduction multiplied by the applicable tax rate. A credit, by contrast, is a dollar-for-dollar reduction in the amount the taxpayer owes.

Table 2.

Illustrative Effect of Limiting the Foreign Tax Credit on the Tax Liability of a U.S. Multinational Corporation

	If There Were No Limit on Tax Credit	Current Law: Tax Credit Limited to Amount Owed If Foreign Income Is Subject to U.S. Taxes
Before-Tax Income (Millions of dollars)		
U.S. Income	100	100
Repatriated Foreign Income	<u>100</u>	<u>100</u>
Total Income	200	200
U.S. and Foreign Tax Liability and the Foreign Tax Credit		
U.S. Taxes Before Foreign Tax Credit		
Rate (Percent)	35	35
Liability (Millions of dollars)	70	70
Foreign Taxes		
Rate (Percent)	40	40
Liability (Millions of dollars)	40	40
Foreign Tax Credit (Millions of dollars)	40	35
U.S. and Foreign Tax Liability After the Credit (Millions of dollars)		
U.S. Taxes	30	35
Foreign Taxes	<u>40</u>	<u>40</u>
Total Taxes	70	75

Source: Congressional Budget Office.

way to limit the ability of businesses to “cross credit” (that is, to use taxes paid to high-tax countries to reduce the U.S. tax on income from low-tax countries). Over time, the per-country limit has been replaced with separate limits for different categories (or “baskets”) of income; the income from all countries is combined within each basket. Before 2007, businesses were required to calculate separate limits for nine different baskets. The American Jobs Creation Act of 2004 reduced that number, moving certain items, such as income from financial services, into a general-income category. There are now just two main categories—general income (largely, active income) and passive income.⁶

6. Active and passive income are discussed in more detail later in this report. The tax code identifies two other categories for special treatment. The first consists of income from investments in countries with which the United States does not have diplomatic relations and from countries that support terrorism: Income in that category is not eligible for a tax credit. The other category consists of income that is sourced (that is, attributed) to foreign countries by treaty; corporations must compute the foreign tax credit separately for that income.

Deferral of Taxes on Foreign Income. Since the enactment of the corporate income tax in 1909, the United States has allowed firms to defer U.S. taxes on the income of foreign subsidiaries until that money is repatriated to the U.S. parent company. An early justification held that no income should be taxed before it is available for use by the taxpayer (just as taxes are deferred on capital gains realizations or pension income until those funds are received). Over time, concern over the ability of businesses to manipulate their foreign income led to proposals to restrict or eliminate deferral of taxes. Advocates defended deferral as a way to protect firms’ ability to compete with foreign businesses in countries with lower tax rates or a territorial approach to taxation. Those competing concerns have led to a deferral system that is somewhat constrained by limits on its use. (Those limits are discussed later in this report in the section “Limits on Deferral.”)

Under current law, U.S. multinational corporations are taxed only on the income of subsidiaries that are incorporated abroad to the extent that the income from those

Table 3.**Illustrative Effect of Deferral on the Tax Liability of a U.S. Multinational Corporation**

	If There Were No Deferral	Current Law: Deferral
Before-Tax Income (Millions of dollars)		
U.S. Income	100	100
Foreign Income Before Foreign Taxes		
Taxable income repatriated to the parent company	50	50
Income reinvested abroad	50	50
Total Income	200	200
Income Subject to U.S. Taxes	200	150
U.S. and Foreign Tax Liability and the Foreign Tax Credit		
U.S. Taxes Before Foreign Tax Credit		
Rate (Percent)	35	35
Liability (Millions of dollars)	70	52.5
Foreign Taxes		
Rate (Percent)	15	15
Liability (Millions of dollars)	15	15
Foreign Tax Credit (Millions of dollars)	15	7.5 ^a
U.S. and Foreign Tax Liability After the Credit (Millions of dollars)		
U.S. Taxes	55	45
Foreign Taxes	15	15
Total Taxes	70	60

Source: Congressional Budget Office.

a. Credit is allowed for foreign taxes attributable to the repatriated foreign income.

operations is repatriated to the U.S. parent in the form of dividends. (Income earned by a branch, by contrast, is taxed as it is earned because branches are treated as legal extensions of the U.S. parent corporation.)

In the previous example (shown in Table 2), the limit on the foreign tax credit reduced the appeal of investing in a high-tax country. By contrast, the ability to defer U.S. taxes on income that is not repatriated increases the appeal of investing in lower-tax countries. Consider again a U.S. parent company that earns \$200 million in before-tax income (see Table 3). Suppose \$100 million of that income is earned from a wholly owned subsidiary in a host country with a tax rate of 15 percent. The multinational corporation in this instance reinvests half of the dividends in its foreign subsidiary and repatriates the rest to the U.S. parent. Without deferral, all foreign earnings would be subject to U.S. taxes. However, under the

current rules, the multinational does not pay U.S. taxes on the \$50 million of the foreign earnings that remain abroad. Only the \$50 million paid to the U.S. parent company is taxed at 20 percent, the amount by which the U.S. tax rate exceeds the foreign tax rate. Thus, deferral reduces the company's U.S. tax liability by \$10 million.

If the multinational repatriates the income in some future year, it will owe U.S. taxes on that income. The firm still benefits, however, by deferring tax liability—and having the use of that money—until that future time.

Using Excess Credits to Shelter Income Repatriated from Low-Tax Countries. Because a firm's foreign tax credit is limited to its U.S. tax liability, income that is repatriated from a country with a higher tax rate than the U.S. rate generates "excess credits" (that is, potential credits from foreign tax liabilities that cannot be used because they

Table 4.

Illustrative Effect of Cross Crediting Under the Foreign Tax Credit on the Tax Liability of a U.S. Multinational Corporation

	High-Tax Country	Low-Tax Country	Total
Before-Tax Income (Millions of dollars)			
Foreign Income	100	100	200
Taxable Foreign Income Repatriated to the Parent Company	100	20	120
U.S. and Foreign Tax Liability Before the Foreign Tax Credit			
U.S. Taxes			
Rate (Percent)	35	35	35
Liability (Millions of dollars)	35	7	42
Foreign Taxes			
Rate (Percent)	40	10	n.a.
Liability (Millions of dollars)	40	10	50
U.S. and Foreign Tax Liability After the Foreign Tax Credit, with No Cross Crediting (Millions of dollars)			
Foreign Tax Credit ^a			
Potential ^b	40	2	42
Allowed ^c	35	2	37
U.S. Taxes	0	5	5
Foreign Taxes	40	10	50
Total Taxes	40	15	55
U.S. and Foreign Tax Liability After the Foreign Tax Credit, with Cross Crediting (Millions of dollars)			
Foreign Tax Credit ^a			
Potential ^b	40	2	42
Allowed ^c	35	7	42
U.S. Taxes	0	0	0
Foreign Taxes	40	10	50
Total Taxes	40	10	50

Source: Congressional Budget Office.

Note: n.a. = not applicable.

- Per-country credits are shown for illustration only and are not calculated separately for U.S. tax purposes.
- The potential credit is the foreign taxes paid on repatriated income.
- The allowed tax credit is the smaller of the potential credit or the U.S. tax liability due on repatriated foreign income.

exceed the amount owed to the United States). A firm that repatriates income from a country with a lower tax rate would receive a credit that was not enough to offset the entire U.S. tax owed on that income, and the firm would face a residual tax in the United States. U.S. tax law, however, allows firms to combine the income and credits from high- and low-tax-rate countries on income tax returns. The excess credits attributed to the taxes paid on income earned in a high-tax country can be cross

credited and applied to the income repatriated from the low-tax country, effectively offsetting some or all of the U.S. tax liability on income from the low-tax host country.

Suppose a firm repatriates \$100 million from a country with a 40 percent tax rate and \$20 million from a country with a 10 percent tax rate (see Table 4). Without cross crediting, the firm could claim a credit of \$35 million on

its income from the high-tax country, the amount it owes under U.S. tax law on \$100 million of earnings. The firm also could claim another credit for \$2 million—the amount owed to the low-tax country on the \$20 million repatriated from that country. However, under current law, that firm has excess credits of \$5 million—the difference between the potential credit (\$40 million) and the allowed credit (\$35 million) from the taxes paid to the country with the higher tax rate. The U.S. firm can still apply the excess credit of \$5 million against the amount due in U.S. taxes on income earned in the low-tax country.

The advantages of cross crediting increase as fewer restrictions are placed on the foreign tax credit.⁷ The current system's smaller number of baskets eases the way for firms to use cross crediting, and thereby increases the use of that mechanism.⁸

Combining Deferral and Excess Credits. Corporations can increase their after-tax income by retaining some earnings abroad in low-tax countries and using excess credits from high-tax countries to shelter income repatriated from low-tax countries. Such actions allow them to avoid paying the U.S. taxes that would have been due on some of their income from low-tax countries. Consider again a firm that initially earns \$100 million in the United States and \$100 million in a country with a 15 percent tax rate. If the company does not defer any income, it would have a U.S. tax liability of \$70 million, less a foreign tax credit of \$15 million, and thus would owe \$55 million in U.S. taxes; its total tax payments would amount to \$70 million (see the first column in Table 3 on page 7). Deferral, by itself, would reduce those taxes by \$10 million (see the second column in Table 3).

Alternatively, the firm could rearrange its investments and use the combination of deferral and cross crediting to reduce its total tax liabilities even more—and eliminate its U.S. tax liability. For example, say the firm moves its domestic and foreign investments to two foreign countries—one with a rate that is higher (40 percent) and the

other with a rate that is lower (10 percent) than the U.S. tax rate (the example shown in Table 4).⁹ If it repatriates \$100 million from the country with the higher tax rate and \$20 million from the country with the low tax rate, the company can use cross crediting to take the full credit of \$40 million—the amount paid to the high-tax country—to eliminate the domestic tax due on income it repatriates from the low-tax country. Thus, by moving investments overseas, retaining some earnings abroad, and using cross crediting, the company could reduce its net U.S. tax liability from \$55 million to zero and its total tax payments from \$70 million to \$50 million.

Deductions for Expenses. Another feature of the tax code that can affect the use of excess credits is the treatment of certain expenses incurred by the parent firm in the course of its general business activities. Such expenses include interest on loans, spending on research and development, and overhead. The foreign tax credit is limited to the U.S. tax liability on repatriated income, net of those expenses incurred in earning the income. Deducting the expenses reduces the allowable credit for firms affected by that limit. However, the lower limit could be used to generate additional excess credits from high-tax countries to shield income repatriated from low-tax countries from U.S. tax liability, thus encouraging some firms to allocate more expenses to their foreign earnings.

Although deductions for expenses related to doing business abroad can reduce the foreign tax credit, those expenses can nevertheless be used in other ways to lower the company's U.S. tax liability. When determining that liability before tax credits, firms need not differentiate between domestic and foreign expenses; all foreign expenses can be deducted entirely against U.S. taxable income to reduce total U.S. tax liability. Thus, expenses from foreign operations reduce U.S. tax liability, even before the application of the foreign tax credit. Moreover, the parent firm can take deductions for expenses it incurs for its foreign operations in the year that those expenses

7. See Kimberly Clausing, "Tax Holidays (and Other Escapes) in the American Jobs Creation Act," *National Tax Journal*, vol. 58, no. 3 (September 2005), pp. 331–346.

8. See Harry Grubert and Rosanne Altshuler, "Corporate Taxes in a World Economy: Reforming the Taxation of Cross-Border Income," in John W. Diamond and George Zodrow, eds., *Fundamental Tax Reform: Issues, Choices and Implications* (MIT Press, 2008).

9. Under both scenarios, the firm would face the same underlying tax rate on the new investments (before accounting for foreign tax credits, deferrals, and other adjustments). In the previous example (see Table 3), the firm faced an underlying tax rate of 25 percent (\$35 million in U.S. taxes and \$15 million in foreign taxes on \$200 million of before-tax income). In this example (see Table 4), it also faces an underlying tax rate of 25 percent (\$40 million in taxes in the high-tax country and \$10 million in taxes in the low-tax country on \$200 million of before-tax income).

are incurred—even if the related foreign income is not repatriated until a later year.

Limits on Deferral. Income is taxed differently according to how it is earned (that is, whether it is passive or active income) and whether it is retained abroad or paid within the tax year to a U.S. parent company. Passive income is derived from businesses that a firm owns but for which the firm has minimal or no involvement in operations. For example, income from the sales of foreign property to related parties would be considered passive.¹⁰ Passive income, often called subpart F income because of the portion of the tax code that specifies its treatment, is taxed as it is earned. Active income is generated by the firm in the management of its business, and it is taxed only when it is returned to the U.S. parent company.¹¹ For example, active dividends are taxed only when they are paid out to the U.S. parent. Additionally, some forms of income, such as interest, rents, and royalties, are taxed currently, regardless of whether they are earned passively or actively, because the money is paid immediately to the U.S. earner.

Because government tax administrators cannot readily identify the source of passive income, it is easier to make financial arrangements to shift passive income to low-tax countries and escape U.S. taxation than it is to do the same with active income. If passive income was not taxed when earned, it would be possible for U.S. multinational corporations to defer paying taxes on all investment income, including that from U.S. businesses, by investing through foreign entities. That is not possible under subpart F because investment in U.S. property by U.S.-controlled foreign corporations is subject to tax. The subpart F rules limit the ability of businesses to shelter from U.S. taxation any passive income, including dividends from stock holdings. The separate limits on foreign tax credits for active and passive income reduce the impetus for corporations to use foreign tax credits related to active dividends that are subject to high foreign taxes as a way to shelter passive income associated with low-tax jurisdictions.

Impact of Foreign Tax Credits and Deferrals on Federal Revenues. In 2008—the latest year for which detailed data are available—12 percent of federal revenues came

from corporate income taxes, and about half of that amount was from multinational corporations claiming credits for taxes paid to foreign governments (see Table 5). Although those 7,242 companies represented only four-tenths of one percent of all U.S. corporations, they earned about 70 percent of total taxable corporate income. In all, U.S. multinational corporations claimed about \$100 billion in foreign tax credits on almost \$700 billion in worldwide taxable income (including domestic income and foreign income repatriated to the United States). The credits reduced those corporations' income tax liability by about 40 percent.¹²

Almost three-quarters of the foreign tax credits were claimed by corporations in the manufacturing sector, and those credits reduced their U.S. tax liability by 55 percent. Total foreign repatriated income is almost 60 percent of worldwide taxable income of the corporations claiming a foreign tax credit (comparing totals on Tables 5 and 6). About 10 percent of repatriated income came from the United Kingdom—a major U.S. trading partner (see Table 6)—and Canada accounted for another 8 percent. More than 9 percent was repatriated from countries often considered to be tax havens for U.S. corporate income because of their low tax rates: Bermuda, Luxembourg, the Cayman Islands, and the Bahamas (see Box 1 on page 13).

Measuring the impact of deferral is more challenging because multinational corporations are not required to report the amount of foreign income that is not repatriated.¹³ The Bureau of Economic Analysis of the Department of Commerce has reported that earnings of U.S. foreign affiliates were, on net, about \$900 billion in 2009 (that total does not include the foreign-branch

12. Some firms can take a deduction for foreign taxes *in lieu of* the credit. Such deductions are estimated to have resulted in forgone revenues of \$0.2 billion in 2011 and are expected to reduce federal revenues by \$1.2 billion over the 2011–2015 period. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015*, JCS-1-12 (January 17, 2012), <http://go.usa.gov/flW>.

13. Information is available from several sources. For example, data on foreign and domestic income are available from financial statements and, with less detail, on the Internal Revenue Service's Schedule M3; data on distributions from CFCs are available on the information returns of those corporations; and repatriated income is reported on the tax form that corporations use to claim foreign tax credits. Still, comparisons involving repatriated income are difficult because the available data sources measure income differently and report income from different types of entities that are not easily linked.

10. Specifically, if a U.S. CFC purchased foreign property and sold it to another foreign subsidiary that was controlled by that CFC—a related party—that income would be deemed passive.

11. 26 U.S.C. §951 et seq. (2006 & Supp.).

Table 5.**Use of the Foreign Tax Credit, by U.S. Industry, 2008**

(Billions of dollars)

Industry	Number of Returns	Worldwide Taxable Income ^a	U.S. Income Tax Before Credits	Credits		U.S. Income Tax After Credits ^c
				Foreign Tax	General Business ^b	
Manufacturing	1,268	384.0	134.4	73.5	4.4	56.1
Services	2,600	68.2	23.9	7.3	2.1	14.3
Mining	109	38.7	13.6	6.8	*	6.5
Information	253	52.4	18.3	4.8	0.8	12.5
Finance, Insurance, Real Estate, and Rental and Leasing	1,769	66.7	24.1	4.3	0.3	19.2
Wholesale and Retail Trade	570	73.1	25.6	2.9	0.6	22.0
Other	673	13.4	4.7	0.7	0.1	3.8
Total	7,242	696.4	244.6	100.4	8.4	134.4

Source: Congressional Budget Office based on data from the Internal Revenue Service.

Note: * = less than \$50 million.

- Total income, consisting of domestic and repatriated foreign income that is subject to U.S. taxes.
- The general business credit combines many of the available business credits, such as the research and development credit and investment credits. Combining the credits provides a uniform method for determining limits on their amounts.
- Including additional credits that are not reported separately.

income of U.S. parent companies).¹⁴ Estimates of the cost of deferral use data on, or assumptions about, the distribution of U.S. corporate income among countries with different tax rates and assumptions about how corporations might respond to changes in tax policy. Some analysts estimate, on the basis of a review of the financial data from 880 companies, that as of May 2011, unrepatriated foreign income totaled \$1.4 trillion.¹⁵ JCT estimates that forgone revenues attributable to deferral totaled about \$16 billion in fiscal year 2012 and that they will amount to a total of \$87 billion from 2011 through 2015, making deferral of taxes on foreign income the largest corporate tax expenditure.¹⁶

Effects of the Federal Tax Treatment of U.S. Multinational Corporations

The current U.S. tax treatment of multinational corporations affects their behavior in ways that have an impact on U.S. tax revenues:

- The different treatment of foreign and domestic operations influences decisions about how much and where companies invest. Economic efficiency—the extent to which resources are allocated in a manner that maximizes their value—is reduced if firms forgo more productive investments because they are avoiding taxation.
- The current U.S. tax code encourages firms to artificially shift reported income abroad and between foreign countries.
- When firms choose to shift either their investments or their reported income abroad, U.S. revenues from corporate income taxes decline.

14. See Bureau of Economic Analysis, “U.S. Direct Investment Abroad: Financial and Operating Data for U.S. Multinational Companies” (November 19, 2012), <http://go.usa.gov/FTf>.

15. Dane Mott and Amy Schmidt, “Accounting Issues: Show Us the Foreign Cash!” *North American Equity Research* (September 12, 2011).

16. See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2011–2015*, JCS-1-12 (January 17, 2012), <http://go.usa.gov/f1W>. Tax expenditures are defined by the Congressional Budget and Impoundment Control Act of 1974 as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.” Estimates of tax expenditures, unlike those for revenues, do not reflect any changes in taxpayers’ behavior in response to changes in the tax code.

Table 6.**Foreign Taxes Paid by and Foreign Taxable Income Repatriated to U.S. Parent Companies for Selected Countries, 2008**

	Number of Returns ^a	Foreign Taxes Paid (Billions of dollars)	Foreign Taxable Income Repatriated	
			(Billions of dollars)	Percentage of Total
United Kingdom	1,142	10.3	39.3	9.5
Canada	2,430	11.0	32.8	7.9
Netherlands	709	7.8	21.5	5.2
Ireland	304	1.7	21.2	5.1
Switzerland	392	2.8	14.5	3.5
Japan	942	3.4	14.1	3.4
Bermuda	224	3.6	13.2	3.2
Luxembourg	202	2.6	10.9	2.6
Singapore	514	0.6	9.3	2.2
Cayman Islands (British)	227	1.3	8.8	2.1
Germany	645	2.1	8.7	2.1
China	590	1.1	8.0	1.9
France	638	2.4	7.5	1.8
Bahamas	116	2.1	6.3	1.5
Hong Kong	434	0.5	4.7	1.1
India	501	1.0	3.6	0.9
Italy	475	1.2	3.5	0.8
British Virgin Islands	82	0.2	1.1	0.3
Total for Selected Countries	n.a.	55.6	228.8	55.4
Memorandum:				
Total for All Countries ^b	7,242	121.2	413.3	100

Source: Congressional Budget Office analysis of data on foreign tax credits from the Internal Revenue Service.

Note: n.a. = not applicable.

- The number of returns for each country is the number on which that country is listed; a single return filed by a U.S. parent company can list more than one country.
- The total number of returns for all countries is the total filed by U.S. parent companies claiming a foreign tax credit.

Location of Investment

The current U.S. tax system encourages firms to consider tax advantages as they choose whether to invest in the United States or in some foreign country:

- The limit on foreign tax credits encourages corporations to avoid investing in countries where tax rates are higher than they are in the United States,
- The ability to defer foreign income encourages firms to invest and retain earnings in low-tax foreign jurisdictions rather than in the United States to avoid paying higher taxes here, and
- The practice of cross crediting provides a further incentive for corporations to make foreign

investments on the basis of their potential tax liabilities rather than their other business interests.

A tax system that combines those three features yields a less efficient allocation of worldwide capital among domestic and foreign jurisdictions because companies can move capital from country to country in part to reduce their tax liabilities. Under the current U.S. tax system, a firm—faced with a choice between a project in the United States and a less productive investment in another country with lower taxes—might select the foreign investment because it yields a higher after-tax return.

The system also leads to an inefficient deployment of U.S. capital, thereby reducing the income of U.S. shareholders and employees. To the extent that firms are able to exploit market power (that is, to earn profits that

Box 1.**Tax Havens**

The term *tax haven* is often applied to countries that do not assess income taxes or that appear to set taxes purposely low to attract investment or income from foreign businesses or individuals. More formal definitions, however, have changed over time and vary among international organizations and governments. Factors other than tax rates are sometimes used to determine whether to call a particular country a tax haven.

The Organisation for Economic Co-operation and Development (OECD), for example, originally identified countries as tax havens if they levied minimal taxes or none at all and if they prevented exchanges of information with foreign tax authorities, exhibited a lack of transparency, and did not require corporations to establish substantial local business activity. In 2000, the OECD identified 35 such countries on the basis of those criteria.¹ Since then, the OECD has classified countries on the basis of their commitment—or lack of a commitment—to developing information exchanges with foreign tax authorities, and it assigns nations to what are known as the white, gray, and black lists.

1. Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs, Progress in Identifying and Eliminating Harmful Tax Practices* (2000), www.oecd.org/document/43/0,3746,en_2649_33745_36153067_1_1_1_1,00.html.

As of May 2012, the OECD had listed three countries that had not substantially implemented information exchanges (Nauru, Niue, and Guatemala); none were black-listed as uncooperative tax havens. On the basis of its current criteria, the OECD does not designate as tax havens many countries that have low tax rates and that do not require corporations to have domestic business operations.

The Government Accountability Office has identified 50 countries as tax havens.² That list includes countries that had been identified by the OECD in the past as tax havens and others that also have had low tax rates for businesses or that offer financial privacy and that, as a result, are considered tax havens by other sources.³

2. Government Accountability Office, *International Taxation: Large U.S. Corporations and Federal Contractors with Subsidiaries in Jurisdictions Listed as Tax Havens or Financial Privacy Jurisdictions*, GAO-09-157 (December 2008), <http://go.usa.gov/f1K>.

3. See Dhammika Dharmapala and James R. Hines Jr., *Which Countries Become Tax Havens?* Working Paper 12802 (National Bureau of Economic Research, December 2006), www.nber.org/papers/w12802; and James R. Hines Jr. and Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, Working Paper 3477 (National Bureau of Economic Research, April 1994), www.nber.org/papers/w3477. Hines and Rice initially developed the criteria used by Dharmapala and Hines to identify 41 countries and territories as tax havens.

are greater than the normal market return) in foreign jurisdictions, that profitability could benefit the U.S. economy. However, that benefit is unlikely to override the negative consequences (such as the loss of income to shareholders and employees) of inefficient allocation of U.S. capital.¹⁷

17. In seeking to exploit market power, it is more likely that a corporation would use the many methods of manipulating returns on intangible assets, including licensing or franchising a brand name, that do not require a change in the location of an investment.

Concerns about tax-motivated decisions by U.S. multinationals to invest in foreign countries sometimes reflect the fear that the United States is losing jobs to other countries where tax rates are lower than they are here. However, the Congressional Budget Office anticipates that, apart from periods of general economic weakness—like the recent severe recession and slow recovery—jobs lost in that way tend to be replaced by others, perhaps in other industries, in other locations, and at different wages. Specifically, a shift of investment by U.S. multinationals to foreign markets can cause a loss of particular U.S. jobs (because a manufacturing plant is closed, for

example, or a new one is not built). But over the long term, the economy as a whole generates enough jobs to compensate for those losses.

Still, the replacement jobs may be in different locations and for workers with different skills and experience. Moreover, unless that shift of investment is replaced by additional investment in the United States from other sources, less capital investment in this country will lead to lower overall wages and incomes for U.S. residents.

It bears emphasis that, although tax considerations matter, many other considerations, such as the quality of a country's labor force and infrastructure, its regulatory environment, and its legal and political institutions, play a role in decisions about where to invest.

The incentives to invest abroad would be different under a worldwide tax system with unlimited foreign tax credits: Firms would face the same tax rate regardless of where they invested because they would receive a credit for all taxes paid abroad whether or not those taxes exceeded the U.S. tax liability on that income. As a consequence, U.S. firms' investments, or capital, would no longer be inefficiently allocated because of tax considerations.¹⁸ Departures from that system yield different tax rates for different investment locations, and economic efficiency is reduced to the extent that companies attempt to respond to those different rates.

Several researchers have tried to estimate how corporate taxes affect corporate investment behavior. One analysis showed that a 1 percentage-point increase in the U.S. tax rate relative to the tax rate in a foreign country increased U.S. multinational corporations' employment and sales in that foreign country by 1.6 percent and 2.9 percent, respectively. However, both the assets and the gross income of U.S. corporations in that country increased even more, suggesting that firms respond to differences in tax rates by shifting reported profits as well as by relocating business activities.¹⁹

18. That efficiency also could be achieved if every country had the same territorial tax system and thus identical effective tax rates on all foreign investments. Allowing unlimited credits also would amount to a U.S. subsidy for foreign governments.

19. See Kimberly A. Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, vol. 62, no. 4 (December 2009), pp. 703–705.

Profit Shifting

Shifting investments to other countries can be quite costly, especially if the investment and the demand for skilled labor must be moved from a high-tax developed country to a low-tax jurisdiction that lacks an appropriate infrastructure or labor force and if goods that are produced abroad must be shipped to distant markets. Many of the tax advantages associated with relocating investment can be achieved—at a lower cost—by profit shifting, which allows businesses to maintain their actual investments in high-tax countries while reporting profits in low-tax jurisdictions.²⁰ Some profit-shifting methods are controversial, and government tax administrators and corporations find themselves at odds over the legality of such financial transactions between U.S. parent corporations and their foreign subsidiaries.

How do firms shift profits from one country to another? Some take advantage of the different tax treatment of entities and income in various jurisdictions, in some cases using rules that allow corporations to disregard, or ignore for tax purposes, income from certain subsidiaries. Another common way to reduce a company's tax burden is for a business to take advantage of transfer pricing—that is, how it sets prices on transfers of property, particularly intangible property (such as licenses to use intellectual property), among related businesses in different countries.

Differing Treatment of Entities and Income. U.S. parent corporations can—for tax purposes—transform their foreign subsidiaries into hybrid entities that shelter income from U.S. and foreign taxes. In a standard hybrid structure, a subsidiary of a CFC is treated as a corporation by the foreign jurisdiction but as what is known as a pass-through entity (for example, a branch of a CFC) under U.S. tax law. That arrangement allows the firm to take deductions in the foreign jurisdiction, but it also allows the income of the subsidiary to pass through to—that is, to be attributed to—the controlled foreign corporation. Thus, transactions between the two entities can be disregarded in calculating U.S. taxes, thereby avoiding U.S. taxes on such transactions. This feature of the U.S. tax system encourages companies to shift investments—and reported profits—abroad.

20. Profit shifting also imposes costs because it requires the use of resources for tax planning.

Such an intercompany transaction occurs, for example, when a subsidiary that is incorporated in a low-tax jurisdiction lends money to a subsidiary incorporated in a high-tax jurisdiction, effectively shifting income to the low-tax country in the form of interest payments. The borrowing subsidiary deducts, at the high tax rate, the interest payments made to the lending subsidiary. For U.S. tax purposes, however, the borrowing subsidiary can be treated as a *branch* of the lending subsidiary, and the income of the borrowing subsidiary is considered the legal income of the lending subsidiary. Therefore, the parent corporation can shield the passive income (the interest the borrowing entity has paid to the lending entity) from the taxation that normally would occur under the U.S. system. By allowing the company to disregard, for tax purposes, the passive income of the hybrid entity in the year it is earned, the tax code effectively defers the repatriation of the income and therefore the tax that will be owed on it.

Under “check-the-box” rules, a business can elect to treat a subsidiary as a separate corporation, a partnership, or a “disregarded entity” that is not treated as separate from its owner.²¹ Those rules allow a corporation to remove a wholly owned subsidiary incorporated abroad from recognition by the U.S. tax system or to treat a partnership as a corporation for tax purposes. The rules were intended to simplify the classification of business entities by allowing multinational corporations to identify the status of an entity on its income tax forms.²² But the rules

21. Most corporate filers do not actually check a box; the classification form includes some automatic classifications that depend on the number of owners and their liability status. For example, an entity is automatically disregarded for taxation if it has a single owner without limited liability, and it is classified as a partnership by default if it has multiple owners, at least one of which does not have limited liability.

22. Although those rules were enacted to simplify the process of classifying and structuring business arrangements, any gain is diminished by the use of such complicated hybrid tax strategies as the “Double Irish” and “Dutch Sandwich” approaches. See Jesse Drucker, “Google 2.4% Rate Shows How \$60 Billion Lost to Tax Loopholes,” *Bloomberg News* (October 21, 2010), www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html. Some observers assert that check-the-box rules add complexity by encouraging corporations to compute taxes under different scenarios to determine which entity status will yield the smallest tax liability. See American Bar Association Tax Section, Task Force on International Tax Reform, “Report of the Task Force on International Tax Reform,” *Tax Lawyer*, vol. 59, no. 3 (2006), pp. 649–743.

also enhance the ability of U.S. parent companies to make use of differences in tax laws to generate tax credits on unrepatriated income or to shield passive income from U.S. taxation.²³

A separate provision enacted in 2006 created the “look-through” rule, which instituted specific classifications of certain types of intercompany payments of CFCs. The look-through rule allows those intercompany payments to escape taxation, permitting much of what check-the-box rules also allow.²⁴ The provision originally was scheduled to expire at the end of 2008 but was extended through 2013. If the look-through rule is extended again, eliminating the check-the-box rules would not be sufficient to restrict the use of hybrid entities to avoid U.S. taxes.

Other features of the U.S. tax code also foster misalignments between deductions and income. U.S. corporations can deduct interest expenses from taxable income, regardless of the expenses’ source. Therefore, a firm can claim the deduction for interest expenses related to foreign operations even if the income from those operations is never repatriated. That aspect of the U.S. tax code allows corporations to reduce the amount of income subject to U.S. taxation by deducting expenses for operations abroad without currently, or maybe ever, paying taxes on the income from those operations. This misalignment between deductions and taxation is attributable to the ability of firms to defer paying taxes on income earned abroad.

Transfer Pricing. U.S. firms also can shift income between countries through intercompany transfer pricing, a method of setting prices for the transfer of property, both real and intangible, between related parties, such as from a parent corporation to a subsidiary. Under Treasury regulations, that price should be determined by the “arm’s length” standard—the price two unrelated parties would agree upon in the open market. However, for intellectual property of various kinds or for intangible assets, such as patents for production techniques, it is difficult to determine what an open-market

23. Similarly, foreign parent corporations can use differences between U.S. tax laws and those of other countries to shield income from taxation at home.

24. For a comparison of check-the-box and look-through rules, see David R. Sicular, “The New Look-Through Rule: W(h)ither Subpart F?” *Tax Notes* (April 23, 2007), pp. 349–378.

price would be, and companies and tax authorities sometimes engage in costly disputes over the correct pricing. Companies have an incentive to underprice the transfer of assets to subsidiaries in low-tax countries and to overprice sales from affiliates in low-tax countries to those in high-tax countries.

A simple example of transfer pricing might involve a U.S. parent corporation's sale or lease of patent rights on a production innovation to a foreign subsidiary located in a low-tax jurisdiction.²⁵ Suppose the parent company developed the idea in the United States, where the research costs could be deducted from the company's taxable income at the U.S. corporate income tax rate. Then, suppose the patent right is sold by the parent company to a subsidiary in a low-tax country. Thereafter, the income from sales of the resulting product (net of production costs) is allocated to the patent holder in the low-tax country, and if production costs are low, most of the receipts will be attributable to that subsidiary. If the transfer price for the patent right is set below the open-market price, the parent company benefits by reducing its reported income in the United States while allocating most of the income generated from use of the patent to the patent-holding subsidiary in the lower-tax country. By reinvesting earnings in the low-tax subsidiary and not repatriating that income to the United States, the company avoids paying U.S. taxes associated with the U.S. invention.

Estimates of Profit Shifting. One study, noted earlier, showed that multinationals increased both real investment and reported profits in a country when its tax rate declined relative to the U.S. rate.²⁶ The analysis showed that a 1 percentage-point increase in the U.S. tax rate relative to the tax rate in a foreign country can increase U.S. multinational corporations' assets (including financial assets that may be unrelated to investment) and gross income (which are related to reported profits) in that country by 4.8 percent and 5.2 percent respectively, whereas employment and sales (which are indicators of real investments) in the host country increased much less. Those results suggest that profit shifting increases more

than investment as a result of increases in the relative tax rate.

Other studies present indirect evidence of profit shifting. Firms can relocate the legal home of their headquarters by merging with a foreign firm or by reincorporating abroad. If the firm relocates its legal headquarters to a low-tax jurisdiction, investments by the corporation are no longer subject to U.S. taxes even though the firm has made no changes to the location of capital. One report showed that an increase in the tax on repatriated income in the home country—assuming nothing else changes—increases the likelihood that a corporation will legally relocate, suggesting that the prospect of paying more in taxes can encourage firms to use accounting or other methods to change the location of the profits they report.²⁷

Some studies show that U.S. business income in low-tax countries is high relative to the actual presence of U.S. businesses in those countries.²⁸ Other research has shown disproportionately large ratios of profits earned by U.S. firms relative to GDP in low-tax countries.²⁹ Recent research has shown that firms' shares of income abroad are increasing but that their share of sales is not.³⁰ Those findings provide further evidence that firms are more likely to shift profits than to relocate investment in response to an increase in the U.S. tax rate relative to rates in other countries.

Budgetary Effects of Decisions About Location and Profit Shifting

Both the movement of investment abroad and the shifting of reported profits reduce income subject to U.S. corporate taxes. Several researchers have attempted

25. For a discussion of other ways to transfer income, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing*, JCX-37-10 (July 20, 2010), <http://go.usa.gov/fiw>.

26. See Kimberly A. Clausing, "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, vol. 62, no. 4 (December 2009), pp. 703–725.

27. Johannes Voget, *Headquarter Relocations and International Taxation*, Working Paper 1008 (Oxford University Centre for Business Taxation, April 2010).

28. Melissa Costa and Jennifer Gravelle, "U.S. Multinational Corporations: Effective Tax Rates and Business Locations," in National Tax Association, *Proceedings of the 103rd Annual Conference* (Chicago, 2010), www.ntanet.org/publications/nta-proceedings/222.html.

29. Jane Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, CRS Report for Congress R40623 (Congressional Research Service, September 3, 2010).

30. Harry Grubert, "Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, are Being Globalized," *National Tax Journal*, vol. 64, no. 2 (2012), pp. 247–281.

to estimate how much tax revenue is lost to the U.S. Treasury through various accounting or other strategies that corporations use to reduce their tax liability on income earned from international transactions. The estimates vary widely—from a low of \$10 billion to a high of \$90 billion per year.

The difference in those estimates is partly the result of what type of avoidance is analyzed, but the choice of research methodology also affects the outcome.³¹ For example, some studies used data on differences in countries' rates of returns, but that method accounts only for profit shifting by U.S. multinationals. In contrast, regression analyses that estimate profit shifting encompass shifts by foreign firms to the United States and by U.S. firms to foreign countries. Those studies yielded the highest estimates of revenue losses. Other studies assess the impact of policy changes on revenue losses, but their results apply only to the specific activity affected by that change.

Policy Options

Among the avenues policymakers and analysts have suggested for changing—fundamentally or incrementally—the way the U.S. tax code treats multinational corporations are the following:

- Move significantly toward a purely worldwide system that limits or eliminates deferral,
- Move significantly toward a territorial system that exempts foreign income from domestic corporate taxation, or
- Prevent multinational corporations from avoiding taxes under the current system, for example, by

restructuring the foreign tax credit or by treating entities and income consistently.

This report discusses some policy options in each of those categories.³² Because the U.S. tax system affects multinationals' decisions about where to invest and how to report profits, those choices have consequences for economic efficiency and U.S. tax revenues—key criteria for evaluating trade-offs between tax policy options. This assessment of each policy option considers its potential effects on the following:

- Firms' decisions about where to invest,
- Firms' decisions about shifting profits from one country to another, and
- U.S. tax revenues.

Some options would dampen incentives to shift capital or profits abroad, thereby increasing economic efficiency and producing more tax revenue, others would bolster those incentives, and a third set could yield conflicting effects on efficiency and revenues (see Table 7). All of the options could be structured to boost U.S. corporate tax revenues, which could be used to reduce the deficit, pay for additional spending, finance reductions in corporate tax rates or other tax changes, or implement some combination of those actions. The economic and budgetary effects of the options would depend greatly on how they were structured.

One important consideration in choosing among options involves firms' responses to different tax rates. For example, if multinational corporations are more likely to artificially shift reported profits than they are to adjust their investment behavior in response to lower tax rates abroad, options designed to limit such behavior may be preferable. Such options would restrict those corporations' ability to use various accounting methods to avoid paying taxes, and they might or might not impede efficient allocation of investments. Alternatively, if firms are more likely to adjust their investment behavior, tax

31. See, for example, Kimberly A. Clausing, "The Revenue Effects of Multinational Firm Income Shifting," *Tax Notes* (March 28, 2011), pp. 1580–1586, and "Multinational Firm Tax Avoidance and Tax Policy," *National Tax Journal*, vol. 62, no. 4 (December 2009), pp. 703–725; Martin Sullivan, "U.S. Multinationals Shifting Profits Out of the United States," *Tax Notes* (March 10, 2008), pp. 1078–1082, and "Shifting Profits Offshore Costs U.S. Treasury \$10 Billion or More," *Tax Notes* (September 27, 2004), pp. 1477–1481; and Charles W. Christian and Thomas D. Schultz, "ROA-Based Estimates of Income Shifting by U.S. Multinational Corporations," in James Dalton and Beth Kilss, eds., *IRS Research Bulletin: Recent Research on Tax Administration and Compliance—Proceedings of the 2005 IRS Research Conference*, Publication 1500 (Washington, D.C., 2005), pp. 57–72, <http://go.usa.gov/gP2R>.

32. For estimates of the revenues that would accrue from adopting some of those options, see Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal*, JCX-27-12 (March 14, 2012), <http://go.usa.gov/gPrA>; and Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011).

Table 7.**Policy Options for the Tax Treatment of U.S. Multinational Corporations**

Policy	Description	Effect on Decisions About:		Change in U.S. Tax Revenue, 2012–2021 (Billions of dollars)
		Investment	Profit Shifting	
Move More Toward a Worldwide Approach				
Eliminate Deferral	Subject all income earned by foreign subsidiaries of U.S. corporations to U.S. taxes but maintain foreign tax credit	Would reduce investment in low-tax countries and could boost investment in high-tax countries	Would reduce shifting of income to low-tax countries	114
Eliminate Deferral For Certain Countries	Eliminate deferral of income from countries with low or no corporate income tax	Would reduce investment in those countries; some firms might shift investment to other countries for which deferral was still allowed	Would reduce shifting of income to those countries; some firms might shift income to other countries for which deferral was still allowed	Uncertain
Eliminate Deferral Related to Goods Produced Abroad	Eliminate deferral of income earned from the sale of certain goods produced abroad	Would reduce investment in the affected countries	Would have little effect on profit shifting	Potentially a small increase
Move Toward a Territorial Approach				
Exempt Active Dividends Earned Abroad from U.S. Taxation	Exempt dividend income earned from investments abroad from U.S. corporate taxes; eliminate deduction for overhead expenses allocated to foreign operations	Would increase incentives to invest in low-tax countries	Would increase incentives to shift income to low-tax countries; would create incentives to characterize payments from foreign subsidiaries as active dividends	76
Apportion U.S. and Foreign Income by Formula	Allocate total income among the United States and other countries on the basis of the fraction of assets, sales, employment, and payroll in each country	Would increase incentives to invest in low-tax countries; the effects might be small	Would reduce the incentive for firms to shift income	Probable increase

Continued

policies that ensure economic efficiency could be more appropriate. However, it is difficult to distinguish between actual changes in investment behavior and those that are purely changes in accounting for profits. Although there is some evidence that firms' investment decisions are affected by changes in the U.S. corporate tax

rate, research findings suggest that firms respond more by artificially shifting their reported profits abroad.

The options presented here specifically address the taxation of foreign income earned by multinational corporations. Although this report does not discuss ways to change the treatment of U.S. corporations' domestic

Table 7. **Continued**
Policy Options for the Tax Treatment of U.S. Multinational Corporations

Policy	Description	Effect on Decisions About:		Change in U.S. Tax Revenue, 2012–2021 (Billions of dollars)
		Investment	Profit Shifting	
Restructure the Foreign Tax Credit				
Determine Foreign Tax Credits on a Pooling Basis	Base the total foreign tax credit on the share of aggregate earnings repatriated from each country	Would increase incentives to invest in low-tax countries, although with little effect	Would increase incentives to keep profits abroad to avoid U.S. taxes on income from subsidiaries in low-tax countries and would reduce shifting of income	57 ^a
Determine Foreign Tax Credits with a Per-Country Limit	Disallow cross crediting by limiting the amount of foreign tax credits allowed from each country	Would increase incentives to invest in low-tax countries, although with little effect	Would increase shifting of income from high-tax to low-tax countries	Potentially small increase
Treat Entities and Income Consistently				
Eliminate Check-the-Box Rules	Allow income from foreign entities to be untaxed only if the entity’s sole owner is legally organized or established within the same country	Would reduce incentives to invest abroad	Would reduce shifting of income from high-tax to low-tax countries	Increase
Defer Interest Deductions Related to Deferred Income	Defer the deduction of interest expenses so that the share of total foreign expenses that is allowed to be deducted is the same as the ratio of repatriated income to total foreign income	Would indirectly increase incentives to invest abroad, although with little effect	Would reduce shifting of income	60 ^a

Sources: Congressional Budget Office and the staff of the Joint Committee on Taxation.

a. The projected change in U.S. tax revenues for this option is for fiscal years 2013 to 2022. It includes the effects of interactions with other proposals in the President’s fiscal year 2013 budget.

operations, the options presented could be combined with other, broader changes to the U.S. corporate tax system. For example, changes in the taxation of multinational firms could be combined with a reduction in the corporate tax rate. One proposal, presented in the 2010 report of the National Commission on Fiscal Responsibility and Reform (often called the Simpson–Bowles commission), would combine a territorial tax system with a reduction of the top corporate tax rate from

35 percent to a rate between 23 percent and 29 percent.³³ Although a territorial system would strengthen the incentive for firms to move operations and reported income abroad, the reduction in the corporate tax rate could

33. See National Committee on Fiscal Responsibility and Reform, *The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform* (December 2010), <http://go.usa.gov/f07>.

offset those incentives and encourage firms to operate in and report their income in the United States.

Other broad proposals involve combining reductions in the corporate tax rate with provisions that would move the tax system toward a more worldwide taxation structure. The President's fiscal year 2013 budget proposal, for example, called for reducing the top corporate tax rate from 35 percent to 28 percent and instituting a minimum tax on income retained in low-tax countries.³⁴ Reducing the corporate tax rate could dampen the incentive for multinational corporations to invest abroad or to change the location of reported income as a way to minimize their tax liability. However, as long as some countries have low corporate income tax rates or none at all, such incentives will never be completely overcome by reducing U.S. tax rates.

Move More Toward a Worldwide Approach

Because the U.S. tax system taxes income earned abroad, it leans toward a worldwide approach. However, deferral of taxes on unrepatriated foreign income gives the tax system some characteristics of a territorial approach. Options that would eliminate or reduce the ability of multinational corporations to defer taxes on foreign income would move the U.S. tax system closer to a purely worldwide system. Some options would prevent U.S. firms from deferring U.S. taxes on foreign income; all income earned by those businesses would be taxed as it is earned. Other options would maintain deferral but limit the types of income that could be deferred as a way to boost economic efficiency and increase revenues by removing incentives to shift income to low-tax jurisdictions or to invest in low-tax jurisdictions solely to avoid paying U.S. taxes.³⁵

Eliminate Deferral. Under this option, all income earned by foreign subsidiaries of U.S. corporations—regardless of whether the income had been repatriated—would be subject to U.S. taxes. To prevent double taxation of foreign income, the foreign tax credit would remain in force, but, as under current law, that credit could not exceed the

U.S. tax liability on foreign income. Because all income would be treated identically and taxed concurrently, however, the U.S. parent corporation's overhead expenses would no longer be allocated between domestic and foreign activities for determining the foreign tax credit.

Eliminating deferral would reduce the movement of capital and reported income to low-tax countries. Income earned abroad would generally be subject to the U.S. tax rate, thus reducing incentives to shift investment or reported income to countries with low taxes. With deferral, firms have an incentive to bring back only as much income from low-tax countries as can be sheltered by the excess credits generated from paying taxes in high-tax countries. Without deferral, the tax advantage of retaining income in a low-tax country would be diminished: All of a corporation's income would now be taxed currently at U.S. rates. Removing that advantage would reduce tax-based motivations to retain income in low-tax countries and encourage companies to redirect those resources to more efficient uses.

Although this option generally would dampen the incentive to shift investment and reported income to low-tax countries, in some circumstances, corporations might still find an advantage in doing so. Deferral might be eliminated, but the rules governing foreign tax credits would not change and the amount of the credit would still be limited to the U.S. tax liability on income earned abroad; firms investing in countries with tax rates above those in the United States would still be able to use cross crediting to avoid paying some tax. Thus, firms with excess foreign tax credits would still find it advantageous to shift investments or reported income from high-tax to low-tax countries. A variant of this option also would limit or eliminate cross crediting, further shrinking the incentive to shift investments to low-tax countries.

Revenue gains resulting from eliminating deferral might be diminished if, in response, corporations shifted investment or reported income from low-tax to high-tax countries. A business that had transferred its income to a low-tax country solely to cut its tax liability, for example, would no longer benefit from retaining income in the low-tax country and might shift that income back to one or more high-tax countries. Such a response could offset the revenue gains to the United States. However, if the option was paired with limits on cross crediting, the tax incentives to shift investments or income to high-tax countries would be reduced.

34. See White House and Department of the Treasury, *The President's Framework for Business Tax Reform* (February 2012), <http://go.usa.gov/fOv>.

35. Eliminating deferral would remove the territorial features of the current tax system but would still not result in a purely worldwide tax system unless the limit on the foreign tax credit was eliminated as well.

Eliminating deferral also could increase the incentive corporations have to incorporate, or register, abroad or to merge with overseas firms, thus reducing U.S. revenue gains in the future. However, the current tax system penalizes U.S. firms that “invert,” or reincorporate abroad. A more worldwide system could encourage emerging businesses to choose foreign incorporation without fear of inversion penalties. (Under the current system, there seems to be little evidence that fledgling firms choose to start up abroad.)³⁶

JCT estimates that eliminating deferral would raise, on net, about \$50 billion between 2012 and 2016 and \$114 billion over the 2012–2021 period.³⁷

Eliminate Deferral for Certain Countries. This option would eliminate deferral of income earned in countries that are considered tax havens, giving corporations less incentive to invest in or shift income to those countries because all of the resulting income would be subject to U.S. taxation as it was earned. Those firms would still have an incentive to shift investment or reported income to other low-tax countries that are not considered tax havens. The net effects on investment and income-shifting are uncertain and have not been estimated.

The effect on U.S. tax revenues also is not clear; it would depend on how firms responded to the new incentives for investment and income shifting. If the shift was from countries considered tax havens to high-tax countries, tax revenues attributable to repatriation could drop as firms relied more on cross crediting. Alternatively, if investment or income was moved to other low-tax countries and repatriated, U.S. tax revenues could rise.

Eliminate Deferral Related to Goods Produced Abroad. This option would eliminate deferral of income from the sale of goods produced abroad and imported to the United States, thus discouraging investment in foreign countries. The option would discourage the building

of “runaway plants,” which corporations use to shift production abroad while they either import the goods to the United States or export them to another country. In the absence of enforceable rules for tracing the path of goods from production to final consumers, U.S. multinational corporations can currently adjust the reported location of their sales, which may or may not require physical transfer of goods, to take advantage of deferral. For example, a firm might transfer goods or ownership of products to another country so that they could be imported back to the United States and the income from that sale would be deferrable. Because this option would target sales of goods abroad rather than transfers of reported income, it probably would have little effect on the shifting of income to low-tax countries.

To the extent that this type of option is enforceable, U.S. tax revenues would probably increase because the option would limit the amount of income corporations could defer. However, the revenue gains could be minimal if the affected goods were produced in high-tax countries, where U.S. corporations can take larger foreign tax credits.

Move Toward a Territorial Approach

The United States could move formally toward a territorial system of taxation in any of several ways, one of which would be to exempt some or all income earned abroad from the U.S. corporate income tax.³⁸ Under one option, dividend income from investments abroad would be excluded from the U.S. tax base; in that case, by setting those dividends, multinational corporations would determine the amount of income earned abroad that would be excluded. Another option would require firms to use a formula, set by law, to distinguish foreign from domestic income. A formula approach is not necessarily limited to a purely territorial system; it could also be applied to a tax system, like the current one in the United States, that leans toward a worldwide system but has deferral.

Exempt Active Dividends Earned Abroad from U.S. Taxation. Exempting active foreign dividends from U.S. taxation would move the country toward a

36. See Eric J. Allen and Susan C. Morse, “Firm Incorporation Outside the U.S.: No Exodus Yet” (unpublished paper, University of California, Hastings College of Law, October 2011), www.works.bepress.com/susanmorse/10.

37. That estimate differs from the tax expenditure for deferral because of adjustments made to account for firms’ behavioral responses (for example, choosing to restructure in favor of foreign branches rather than subsidiaries) in the estimates for policy options. See Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2011), p. 186.

38. For a comparison of options to eliminate deferral and exempt dividends, see Rosanne Altshuler and Harry Grubert, “Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income,” in John W. Diamond and George R. Zodrow, eds., *Fundamental Tax Reform: Issues, Choices, and Implications* (MIT Press, 2008).

territorial tax system; active dividends from investments abroad would not be subject to domestic corporate taxes. All other forms of foreign income, including royalties, interest payments, and income from passive activities, would be taxed as they are under current law—as the income is earned.³⁹ Under this option, overhead expenses that are allocated to foreign operations (such as interest expenses generated by foreign subsidiaries' borrowing) would no longer be deductible because the income associated with those expenses would never be subject to U.S. taxation.

Exempting active foreign dividends would tend to increase investment in and reported income from low-tax countries. The option would make investment behavior by U.S. firms less efficient by increasing incentives to invest in low-tax countries.⁴⁰ Without a tax on repatriated dividends, U.S. multinational corporations would prefer to locate as much income as possible in the lowest-tax countries and would have more incentive to shift their reported income to such countries. Additionally, firms would have an incentive to characterize payments from foreign subsidiaries as active dividends because they would be exempt from U.S. taxation.

In general, countries with territorial (or exemption) tax systems collect less revenue, all else being equal, than they would with worldwide tax systems.⁴¹ However, for two reasons, this option could raise revenues, despite the exemption of foreign dividends from taxable income: The option would restrict the ability of firms to deduct expenses associated with foreign operations, and it would more effectively tax income from royalties.⁴² Other methods of exempting dividends could result in revenue losses.

All expenses now are deductible regardless of their source. Under this option, overhead expenses allocated to foreign

operations would no longer be deductible and a corporation's taxable income would, according to JCT, increase enough to more than offset the Treasury's loss from not taxing active foreign income. If firms were allowed to continue to deduct all overhead expenses, including those associated with foreign operations, this option would probably result in a significant revenue loss.

This option also could result in added federal tax revenues because receipts from taxes on royalty income would probably rise once dividends were exempted. Current law subjects income from royalties to U.S. taxation. However, firms are able to use excess foreign tax credits generated by dividends from high-tax countries to cross credit against U.S. taxes on royalty income, allowing much of that income to escape U.S. taxation. Under this option, those dividends—once exempted from U.S. taxation—could not be used to generate excess foreign tax credits, thus increasing the likelihood that royalty income would become taxable.⁴³

JCT has estimated that this option would increase revenues by about \$32 billion from 2012 through 2016 and by \$76 billion from 2012 through 2021.⁴⁴

Apportion U.S. and Foreign Income by Formula. Another path to a territorial-type system would be to institute what is known as formula apportionment. Some observers consider this approach a simpler alternative to the current transfer-pricing rules, which require arm's-length pricing that is difficult to enforce. Under formula apportionment, before-tax income would be allocated to the United States and other countries according to a formula that accounted for the fraction of assets, sales, employment, and payroll a corporation had in each country, rather than relying on the taxpayer's reports of their income reflecting the transfer prices it had set.⁴⁵ The

39. Unlike dividends, other types of active income (such as interest payments, fees, or royalties) are taxed when they are earned because they flow directly to the parent company. All passive income is taxed as it is earned under subpart F of the Internal Revenue Code.

40. There could be efficiency gains for the U.S. economy to the extent that the overall tax on capital was reduced. Determining the net effect is difficult and depends on the details of the option.

41. Territorial approaches are sometimes referred to as exemption systems because they exempt, subject to anti-abuse rules, foreign income from taxation.

42. Kimberly A. Clausing, "Corporate Tax Revenues in OECD Countries," *International Tax and Public Finance*, vol. 14, no. 2 (April 2007), pp. 115–133.

43. For discussion of the effects of exempting dividends, see 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*, vol. 54, no. 3 (December 2001), pp. 787–809; and Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," *National Tax Journal*, vol. 54, no. 3 (December 2011), pp. 811–827.

44. Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options* (March 2010), pp. 187–188.

45. Net income, rather than gross income, would be allocated, causing the deductions for expenses also to be allocated proportionately to foreign income. As a result, deductions against foreign income would be higher than they are under the current system.

income allocated to the United States would then be subject to U.S. taxation.

Another type of formula apportionment would separately address the allocation of income from intangible assets, such as patents and trademarks, because that allocation is not readily observable. Such an approach would assign normal returns from an investment—that is, the return that would be expected to cover the cost of investment—to the country where the costs of producing the income are incurred and assign any remaining income (the income from intangible assets) on the basis of where the products are sold.⁴⁶

With allocation on the basis of a formula, there would be fewer disputes between the tax authorities and taxpayers regarding the amounts that are reported as income. The formula would be statutory and based on actual business activity, so U.S. firms would find it more difficult to avoid taxes by moving reported income abroad. But because they would still have an incentive to locate real investment in countries with lower tax rates, this option would not reduce inefficiencies from decisions about where to locate investments.

In the United States, some states have already adopted formulas that determine taxable corporate income by the fraction of the corporation's sales, employment, or physical assets (or some weighted combination of each factor) within the state.⁴⁷ The European Union has proposed a similar form of formula apportionment under which taxable income would be determined using a weighted fraction of the share of sales, payroll, employment, and assets in a given country.⁴⁸

Some important practical considerations could hamper the adoption of an apportionment system, however. For example, other countries might retaliate if the

United States were to implement such a system without renegotiating its tax treaties and trade agreements.⁴⁹ Such concerns have led the European Union to limit its proposal for formula apportionment to its member countries.

Moreover, formula apportionment imposes an implicit tax on each factor used in the formula, which could reduce investment by discouraging companies from hiring workers or accumulating assets in high-tax countries (including the United States). As a result, those firms might shift their investments to low-tax countries, thus reducing U.S. tax revenues and increasing inefficiency. In addition, without coordination between countries, under this option some income could be taxed twice: Income would be treated as though derived from domestic sources and taxed in the United States, even though it was earned abroad and might be taxed by the host country as well.

Possible inefficiencies stemming from multinationals' incentives under the formula to change the location of investments would be mitigated by other factors that—both under current law and under the option—restrict movement in real activity. For example, firms might find it costly to transport materials or could find themselves constrained by the need to locate in a country where demand for their goods or services is high. Because capital is more mobile than customers, a formula that gave greater weight to the fraction of sales in a given country also would reduce the incentive to move production to a country that did not have a significant consumer market for the product.

This option would generally make it more difficult to shift reported income abroad because income would be allocated on the basis of relatively immobile factors, such as employment and sales. However, corporations could still take steps to minimize their taxes, especially if income was assigned in part according to the location of assets. For example, financial assets are relatively mobile and could be moved by firms trying to reduce their tax liability. The alternative approach, with separate allocations for income and intangible assets, would further

46. For discussion of this approach, see Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split," *Florida Tax Review*, vol. 9, no. 5 (2009), pp. 497–553.

47. See Federation of Tax Administrators, "State Apportionment of Corporate Income" (May 2012), www.taxadmin.org/fta/rate/tax_stru.html.

48. For a discussion of the consequences of such a change, see Michael Devereux and Simon Loretz, *The Effects of EU Formula Apportionment on Corporate Tax Revenues*, Working Paper WP 07/06 (Oxford University Centre for Business Taxation, April 2007), www.sbs.ox.ac.uk/centres/tax/papers/Pages/paperWP0706.aspx.

49. For a discussion of the complexity of implementing formula apportionment, see Joanne Martens Weiner, *Formulary Apportionment and Group Taxation in the European Union: Insights from the United States and Canada*, Taxation Papers, Working Paper 8 (European Commission, 2005), http://ec.europa.eu/taxation_customs/common/publications/services_papers/working_papers/index_en.htm.

constrain income shifting by allocating income on the basis of production costs and sales and reducing corporations' ability to strategically locate expenses and income in different countries.

By using measures of actual business activity to allocate income between domestic and foreign sources instead of allowing firms to identify sources of income, this option would probably increase U.S. tax revenues. Because it would primarily impede corporations' efforts to shift reported profits as a way to avoid U.S. taxation, however, firms might respond by shifting their investments to low-tax countries, and the revenue gains from the option would be reduced.

Other Options

Two other types of options would address tax avoidance as it is permitted under the current system: restructuring the foreign tax credit and providing a system of more consistent treatment of various entities and income.

Restructure the Foreign Tax Credit. Although opportunities for cross crediting are limited because statutory corporate tax rates are generally higher in the United States than they are in other countries, some researchers still report significant use of cross crediting by U.S. multinational corporations.⁵⁰ Those results suggest that effective corporate tax rates, which reflect both the statutory rates and other features of the tax system, are lower in the United States than in some other countries (see the appendix for a discussion of effective rates).

Concern over corporations' use of excess foreign tax credits to offset tax liabilities in low-tax countries has led to suggestions that the foreign tax credit should be restructured. Under one option, credits would be determined by "pooling"—limiting the total foreign tax credit according to the share of a firm's total foreign income that is repatriated to the U.S. parent company. Another option would limit the foreign tax credit that a corporation could claim for every country separately. Both options would affect repatriation of income by corporations that amass an excess of credits to shield repatriated income from taxation in the United States. The effects of such provisions

on U.S. tax revenues would depend on firms' ability to adjust their repatriations or allocations of worldwide income. If modifications to the foreign tax credit were paired with an option that substantially reduced deferral or eliminated it altogether, those companies would be more likely to repatriate income, thus increasing U.S. tax receipts.

Determine Credits on a Pooling Basis. Under this option, foreign tax credits would be determined by pooling the firm's earnings from all foreign countries, and the total credit would be set according to the percentage of those aggregate earnings that are repatriated.

In general, the option would reduce the foreign tax credit. As an example, consider a multinational corporation with gross earnings of \$100 million from each of two subsidiaries—one in a country with a corporate tax rate of 12.5 percent and one in a country with a 40 percent tax rate (see Table 8). The firm pays a total of \$52.5 million in foreign taxes. Suppose it repatriates all of its net earnings—\$60 million—from the subsidiary in the high-tax country (\$100 million in dividends minus the \$40 million paid in taxes) but only \$19.5 million from the subsidiary in the low-tax country (\$22.3 million in dividends minus \$2.8 million in taxes). In total, the firm pays \$42.8 million in foreign taxes on the income repatriated to the United States. The foreign tax credit on the repatriated income also is \$42.8 million—the top U.S. corporate rate of 35 percent applied to the repatriated gross income (that is, the income repatriated to the United States, including the foreign taxes that have been paid on that income, or \$122.3 million). Thus, under current law the firm can take foreign tax credits equal to 82 percent of the total foreign taxes it paid (\$42.8 million divided by \$52.5 million). Under this scenario, the parent company has repatriated enough income from the subsidiary in the low-tax country to use up the excess credits from the subsidiary in the high-tax country.

Under the option, credits would be assigned according to the amount of pooled foreign income, and the computation of foreign taxes paid would differ from that under current law in two key regards. First, the computation would start with the total amount of taxes paid to foreign entities (\$52.5 million, in the example). Then, that total would be allocated among countries based on the share of total before-tax foreign earnings repatriated from each country.

50. Harry Grubert and Rosanne Altshuler, "Corporate Taxes in a World Economy: Reforming the Taxation of Cross-Border Income," in John W. Diamond and George Zodrow, eds., *Fundamental Tax Reform: Issues, Choices and Implications* (MIT Press, 2008).

Table 8.**Example of Pooling to Determine Credits**

(Millions of dollars)

	Low-Tax Country	High-Tax Country	Total
Foreign Income			
Before-Tax Earnings	100.0	100.0	200.0
Foreign Tax Rate (Percent)	12.5	40.0	26.3 ^a
Foreign Taxes Paid on All Earnings	12.5	40.0	52.5
Repatriated Income	19.5	60.0	79.5
Repatriated Income Before Foreign Taxes			
Millions of dollars ^b	22.3	100.0	122.3
As a percentage of total before-tax earnings in both countries	11.1	50.0	61.1
Taxes Under Current Law^c			
U.S. Taxes Before Foreign Tax Credit	7.8	35.0	42.8
Foreign Taxes Paid on Repatriated Income ^d	2.8	40.0	42.8
Foreign Tax Credit with Cross Crediting	7.8	35.0	42.8
U.S. Taxes After Foreign Tax Credit	0	0	0
Taxes Under a Pooling Option			
U.S. Taxes Before Foreign Tax Credit	7.8	35.0	42.8
Foreign Taxes Deemed Paid on Repatriated Income ^e	5.9	26.3	32.1
Foreign Tax Credit	5.9	26.3	32.1
U.S. Taxes After Foreign Tax Credit	1.9	8.7	10.7

Source: Congressional Budget Office.

- a. Amount is the average tax rate across the two countries.
- b. Repatriated income is "grossed up" to include the amount of taxes paid on that income to the foreign country; the value of the repatriated income is divided by one minus the tax rate of the country from which the income is repatriated.
- c. Per-country credits are shown for illustration only and are not calculated separately for U.S. tax purposes.
- d. Amount is the difference between grossed-up dividends and repatriated dividends.
- e. Amount is the product of total foreign taxes paid in both countries and grossed-up dividends in a particular country as a percentage of before-tax earnings in both countries.

In the example, the subsidiary in the low-tax country repatriated about 11 percent of the \$200 million that the corporation earned through its operations in both foreign countries, and the subsidiary in the high-tax country repatriated 50 percent. The share of foreign taxes attributed to the low-tax subsidiary would be \$5.9 million (11 percent of \$52.5 million) and the share attributed to the high-tax subsidiary would be \$26.3 million (50 percent of \$52.5 million). The total would be \$32.1 million and, under the pooling option, the foreign tax credit also would be \$32.1 million. Thus, under the pooling option, the firm can take foreign tax credits only to the extent that those credits equal 61 percent of foreign taxes.

The foreign tax credit is smaller under the pooling option—in this example, it is reduced by \$10.7 million—because the firm repatriated just 61 percent of its foreign income, and the credit would be limited to that share of the total foreign taxes the firm had paid. Under current law, the firm can claim a credit for more foreign taxes by repatriating more from high-tax countries than from low-tax countries. The pooling provision would reduce the amount of the credit because it would require a shared allocation.

The net effect on corporations' investment is not clear but probably would be small. Limiting the ability to cross credit could shift investment from high-tax to low-tax countries because corporations would not benefit as

much from the larger tax credits. Firms also might respond to the higher taxes on repatriated income by increasing investment abroad and retaining more of the resulting earnings. The effects probably would be small, however, because the additional tax benefits would be insufficient to compensate for the barriers to moving investments abroad.

Nevertheless, determining foreign tax credits by pooling would have implications for the way firms allocate their income. As the example above shows, this option would restrict firms' ability to use excess credits from countries with high taxes to offset the U.S. corporate tax on income from countries with low taxes. It would thereby reduce the incentive to shift reported profits strategically between high-tax and low-tax countries to take advantage of cross crediting and deferral.

Some income from subsidiaries in high-tax jurisdictions would be taxed at a substantially higher rate under the option than would be the case under current law. (In this example, the firm would pay the \$40 million in taxes to the high-tax country, both under current law and with pooling, but the pooling option would require the firm to pay U.S. tax of \$8.7 million in excess of the allowable foreign tax credit). That effect would be mitigated somewhat by the higher foreign tax credit imputed to the income repatriated from the lower-tax country (\$5.9 million, compared with \$2.8 million permitted under current law).

Corporations generally would no longer have an incentive to strategically choose individual subsidiaries from which to repatriate income because taxes would be proportionately assigned to each country and would not be linked to the individual subsidiary. In general, however, firms would still have an incentive to keep profits abroad to avoid paying U.S. taxes on income from subsidiaries in low-tax jurisdictions. Indeed, that incentive would be stronger because of the decline in the potential value of the foreign tax credit.

JCT estimates that adopting this option (the same as that proposed in the President's 2013 budget) would increase revenue by \$25 billion between fiscal years 2013 and 2017 and by \$57 billion between fiscal years 2013 and 2022.⁵¹

Determine Credits with a Per-Country Limit. Another option would disallow cross crediting by limiting the

amount of credits allowed from each country. By requiring firms to compute a separate foreign tax credit for income earned in each country, a per-country limit, like that in effect in the United States between 1932 and 1976, would prevent firms from using repatriated income from a high-tax country to shield income from a low-tax country.

By eliminating the ability of firms to cross credit by combining the income from high-tax and low-tax countries, this option would bolster the incentive to reinvest income in low-tax countries rather than repatriate it. Firms also would have an incentive to shift income from high-tax to low-tax countries. However, to the extent that income in low-tax countries is derived from passive activities, those firms could no longer shield the income from U.S. taxation through the use of excess foreign tax credits. It is not clear whether net repatriated income would decline as a result, but if repatriation responses were small, U.S. tax revenues would increase.

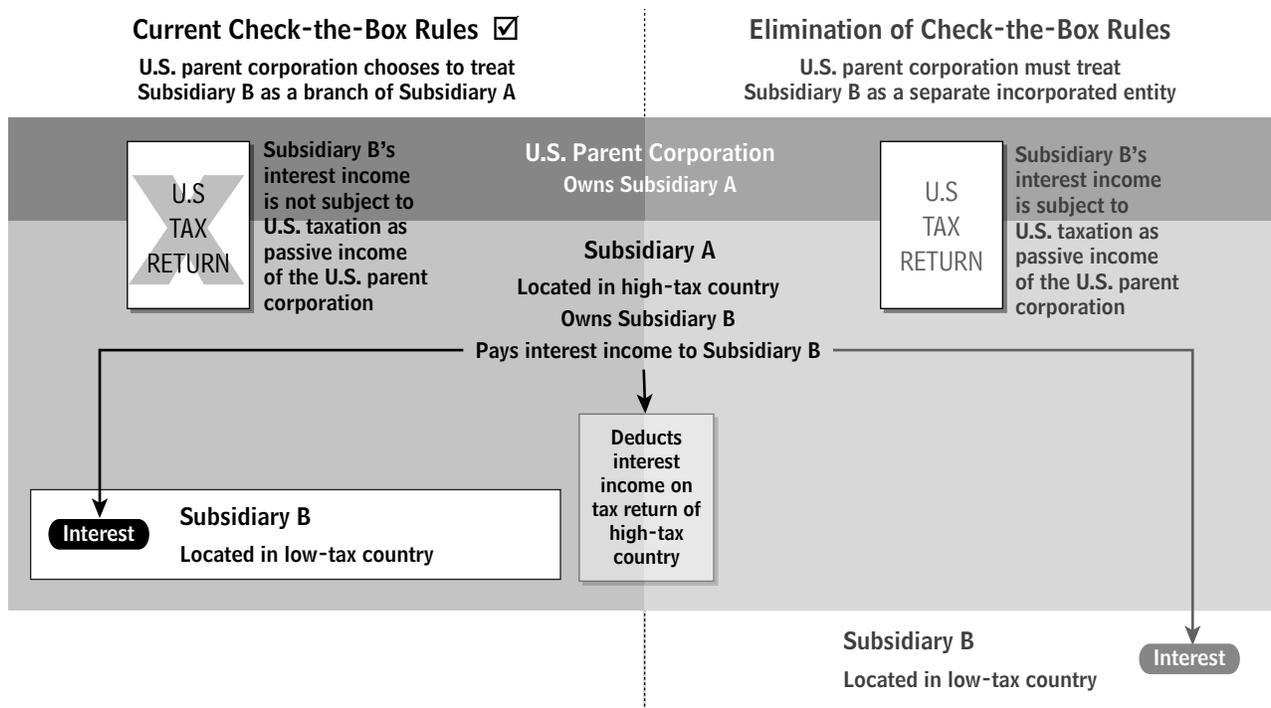
A disadvantage of the option is its complexity. Firms would have to report the sources of income and calculate credits separately for each country instead of combining income from all countries under an aggregate credit as they do under current law. Large multinational corporations with multiple tiers of subsidiaries in different countries would face an especially large additional filing burden.

Treat Entities and Income Consistently. Another approach would be to incrementally change the taxation of U.S. multinational corporations by treating different forms of business entities and income more consistently than current law does. One option would repeal the check-the-box rules that allow U.S. multinationals to treat subsidiaries differently for U.S. tax purposes than they are treated by foreign jurisdictions. Another would preclude U.S. corporations from claiming interest deductions related to foreign income that stays abroad and out of reach of U.S. taxation. Both options generally would increase U.S. tax revenues because they would constrain the ability of firms to shift reported income from the United States to low-tax countries. However, they also could reduce economic efficiency if corporations

51. Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal*, JCX-27-12 (March 14, 2012), <http://go.usa.gov/gPrA>.

Figure 1.

Effect of Check-the-Box Rules Under Current Law and If Eliminated



Source: Congressional Budget Office.

responded by moving their investments to low-tax countries.

Eliminate Check-the-Box Rules. U.S. parent corporations currently can choose to shield the passive income of certain solely owned foreign subsidiaries from U.S. taxation by checking a box on their tax returns. (Under normal circumstances, the income would be subject to U.S. taxation under the subpart F rules that govern passive income.) Check-the-box rules allow multinational corporations to create and use hybrid business entities, which are treated differently by foreign tax authorities than they are by the United States. In a simple case, a parent company owns a Subsidiary A, which it has incorporated in a high-tax country. Subsidiary A wholly owns Subsidiary B, which is located in a low-tax country (see Figure 1). Subsidiary A borrows \$100 million from Subsidiary B, and because Subsidiary B is a separate corporation, Subsidiary A is allowed to deduct its interest payments on the loan from its income on its tax return in the high-tax country. But Subsidiary B is treated as a branch of Subsidiary A for U.S. tax purposes under the

check-the-box rules, and the U.S. tax code considers the income received by a branch (B, in this example) to be the legal income of the parent (A, in this example). Thus, under U.S. tax law, the interest payment, in effect, is treated as an internal transaction within Subsidiary A. As a result, the interest income received by Subsidiary B escapes U.S. taxation.

Those rules facilitate shifting income from high-tax countries to low-tax countries by multinational corporations and encourage firms to shift investment and reported profits abroad to avoid paying U.S. taxes. By making interest payments to subsidiaries in low-tax countries and deducting those payments in high-tax countries, the firms effectively shift that income from subsidiaries in high-tax countries to subsidiaries in low-tax countries. Furthermore, those payments, which would be considered passive income and subject to U.S. taxation, are shielded from U.S. taxes by the check-box-rule that allows Subsidiary B to be treated as part of Subsidiary A. As a result, the interest payments are not considered income under current U.S. tax law.

This option would require that income from foreign entities be excluded from taxable income only if that entity's sole owner is legally organized or established within the *same* country. That restriction would constrain U.S. parent corporations' ability to shift income from high-tax to low-tax countries through payments of passive income that currently escape taxation under subpart F. Passive income payments made between two entities could still be excluded from taxable income as long as both were in the same country.

The advantages of investing abroad would decline under this option because firms would lose the ability to shield certain income from those investments. There would be no advantage to shifting income because payments would be taxed at the same time and at the same rates as the corresponding deductions. Moreover, U.S. tax revenues would increase because passive income from solely owned subsidiaries would not be shielded from U.S. taxation. (However, if the look-through rule provision was extended beyond 2013, eliminating check-the-box rules would not prevent firms from shielding intercompany payments from U.S. taxation.)

Defer Interest Deductions Related to Deferred Income. U.S. multinational corporations can deduct interest expenses from their taxable income. Those expenses are not allocated between foreign and U.S. sources for purposes of determining deductions against gross income that is subject to U.S. taxation. However, for determining the limit on the foreign tax credit, interest expenses are allocated to foreign and domestic sources in proportion to the ratio of foreign assets to total assets.

This option would defer the deduction of interest expenses allocated to foreign income that is not currently subject to U.S. taxation. The proportion of all foreign-related deductions allowed would be the same as the ratio of taxable foreign income to total foreign income. The foreign tax credit would still be determined by allocating all expenses according to the share of a company's total assets in each country.

In general, requiring interest deductions to be deferred until the associated income is repatriated would provide an incentive for corporations to accelerate repatriation. Still, increased repatriation could come from countries with higher taxes, and firms could still use cross crediting to shield income repatriated from low-tax countries under this option.

By making it more costly for corporations to shift income abroad, this option might cause firms to respond by adjusting their investments to avoid an increase in tax liability. Nevertheless, the targeted nature of this option would probably produce little change in investment. The incentives to shift income would decline, because firms could no longer immediately claim deductions for expenses associated with foreign operations when taxes on the income earned from those activities was deferred.

JCT estimates that adopting this option (which was proposed in the President's 2013 budget) would increase revenue by \$28 billion between fiscal years 2013 and 2017 and by \$60 billion between fiscal years 2013 and 2022.⁵²

52. Joint Committee on Taxation, *Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal*, JCX-27-12 (March 14, 2012), <http://go.usa.gov/gPrA>.



Appendix: Corporate Tax Rates

Corporate income tax rates are specified by the tax code. However, the actual tax rates that a firm faces differ from the rates in the tax code—the statutory tax rate—because of other provisions in the code that affect its tax liability. Both the statutory rates and those that the firm actually pays can be compared among countries to analyze the tax burdens firms face in different countries.

Statutory Corporate Income Tax Rates

Most developed countries—including all members of the Organisation for European Co-operation and Development (OECD)—tax corporate income, typically at the national and the subnational (state or province, for example) levels. Statutory tax rates on corporate income differ from one country to another. In 2011, the top rates among the 34 members of the OECD ranged from 12.5 percent in Ireland to 39.5 percent in Japan (see Figure A-1). Those rates combined the top national statutory corporate tax rate—that is, the tax rate that applies to income in the highest tax bracket—in each country with the average corporate tax rate set at the subnational level of government.¹ In 2011, the top U.S. federal statutory rate on business income that was subject to the corporate income tax was 35 percent, and the average top statutory rate imposed on that income by states was about 6 percent—for a combined top statutory rate of 39.1 percent (after accounting for the fact that state taxes are deductible from federal taxable income).

1. For each country in which subnational corporate taxes are deductible from national taxes, as in the United States, the combined statutory tax rate is the sum of the national and subnational tax rates minus the product of the national and subnational statutory rates, which amounts to the value of the deduction.

Weighted by gross domestic product, the average combined tax rate for current OECD countries, excluding the United States, was 29.1 percent* in 2011. (That average probably declined in 2012 because Japan cut its top corporate tax rate—at the national level—in April from 30 percent to 25.5 percent, making the statutory U.S. tax rate the highest among OECD member countries.)² Although the majority of OECD countries have a top corporate tax rate of at least 25 percent, some countries have rates that are so low (sometimes zero) that they are considered tax havens, attracting both investment by and reported income from multinational corporations (see Box 1 on page 13). [*Calculated rate corrected on February 26, 2013]

Average Tax Rates

Statutory rates may not represent the tax rate that multinational corporations actually face. Because of the graduated rate structure, deductions, credits, and other business tax provisions (such as favorable depreciation allowances and credits for certain activities), the average tax rates that corporations pay—the ratio of total taxes to aggregate income—are generally below the top statutory rates. For example, the average rate faced by U.S. domestic firms with no foreign operations between 2005 and 2009 was about 10 percentage points lower than the statutory rate.³

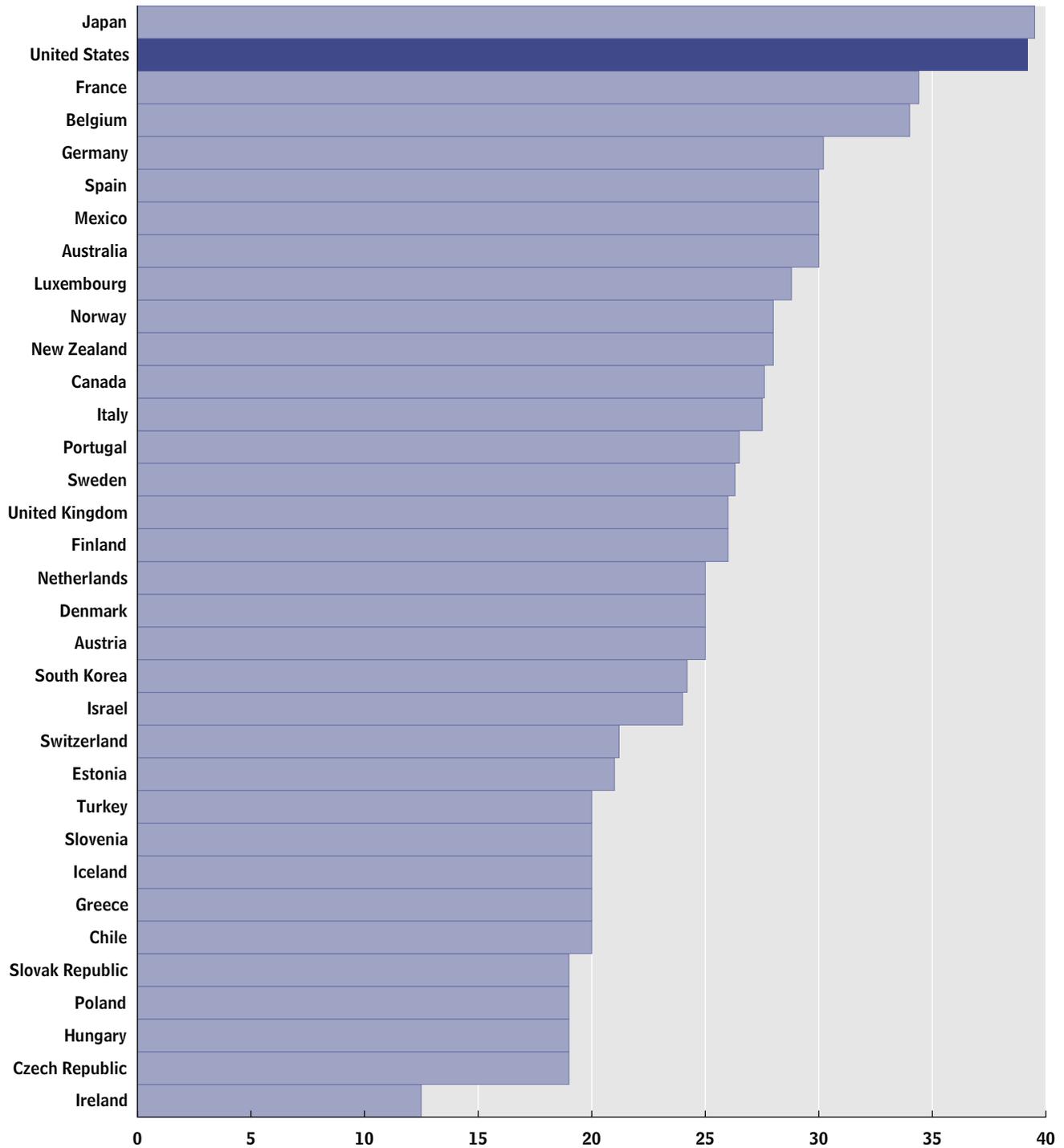
2. Japan added a 10 percent surtax for three years, raising the rate to 28.01 percent (excluding local taxes).

3. For a comparison of the average U.S. tax rate with that of selected other countries, including major trading partners, see Kevin Markle and Douglas Shackelford, *Cross Country Comparisons of Corporate Income Taxes*, Working Paper 16839 (National Bureau of Economic Research, February 2011) www.nber.org/papers/w16839.

Figure A-1.

Combined Corporate Income Tax Rate of OECD Countries, 2011

(Percent)



Source: Congressional Budget Office based on data from the Organisation for Economic Co-operation and Development (OECD).

Note: The combined corporate income tax rate is the rate charged at the national and subnational (state or province, for example) levels.

Effective Marginal Tax Rates

Another way to compare corporate tax rates among countries is to look at the effective marginal corporate tax rate—the rate of tax paid on an additional dollar of income. Like average tax rates, effective marginal tax rates take into account tax preferences as well as the statutory tax rate.

Corporations generally consider their marginal tax rates when they assess whether to make additional investments in ongoing projects. In contrast, average tax rates are more relevant when considering substantial investments, such as those required for building manufacturing plants abroad. As a result, average tax rates could carry more weight than marginal rates do in the calculations that determine whether a company will make a large new investment in a particular country.

Effective marginal tax rates depend on several factors, but two in particular—the treatment of depreciation and the treatment of financing—largely determine the differences between statutory rates and effective marginal tax rates. Consequently, an important component of the after-tax cost of using a capital asset is the rate at which it can be fully depreciated for tax purposes, which is specified in

law for U.S. firms. (That rate may differ substantially from the rate at which the actual value of the asset decreases over time.)

Under U.S. tax law—unlike that in the other OECD countries—the rules for depreciation tend to favor investments in machinery over investments in industrial structures. Combining those depreciation rules with the relatively high U.S. statutory tax rates, the corporate income tax in the United States distorts, to a greater degree than occurs in most other OECD countries, the incentives for marginal investment that are associated with the choice between machinery and structures. Marginal tax rates in the United States are similar to those in other OECD countries for equity-financed investments in machinery, they are substantially above the average for equity-financed investments in industrial structures, and they are substantially below the average for debt-financed investments in machinery.⁴ (Businesses finance investments either through equity—by selling ownership shares or stock—or through debt.)

4. See Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons* (November 2005).

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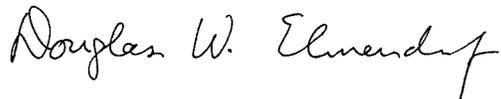
About This Document

This report of the Congressional Budget Office (CBO) was prepared at the request of the former Chairman of the Senate Committee on the Budget. In keeping with CBO's mandate to provide objective, impartial analysis, this study makes no recommendations.

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