Taxing Multinational Corporations

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Introduction

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This growing worldwide importance of international business activities has in recent years lead to serious reexaminations of the ways that governments tax multinational corporations. In the United States, much of the debate concerns the competitive positions of U.S. firms in international product and capital markets. In addition, there are those who argue that U.S. international tax rules have become more complex and more distorting in recent years, particularly since the passage of the Tax Reform Act of 1986. Discussions in the U.S. Congress and the administration since 1992 reveal a willingness to consider significant reforms. In Europe, increased liberalization of capital markets prompted the European Commission to discuss harmonization of corporate taxation. These policy developments not only suggest dissatisfaction with certain features of modern tax practice, but also raise deeper questions of whether current systems of taxing international income are viable in a world of significant capital market integration and global commercial competition.

Academic researchers have expressed renewed interest in studying the effects of taxation on capital formation and allocation, patterns of finance in multinational companies, international competition, and opportunities for income shifting and tax avoidance. This research brings together the approaches used by specialists in public finance and international economics. The papers presented in this volume summarize the results of a research program of the National Bureau of Economic Research on the effects of taxation on the invest-

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ment and financing decisions of multinational corporations.[1] As a group, the papers describe the impact of U.S. firms' outbound foreign investment on the U.S. and foreign economies. The papers offer empirical evidence documenting channels through which tax policy in the United States and abroad affects plant and equipment investment, spending on R&D, the cost of debt and equity finance, and dividend repatriations by U.S. subsidiaries. The findings of these papers, described briefly below, will be useful in discussions of reforms of international tax rules in the United States and elsewhere. The current U.S. rules for taxing international income are summarized in an appendix at the end of the volume.

According to Robert Lipsey, overseas production contributes to the ability of American multinationals to retain world market shares in the face of a long-term decline in the U.S. share of world trade, and in the face of short-term changes (such as exchange rate fluctuations). Overseas production performs the same functions for Swedish firms and, more recently, for Japanese firms. Within U.S. multinationals, those with higher shares of production overseas have higher employment at home relative to production at home. Foreign production appears to require larger numbers of employees in headquarters activities (including R&D and supervision).

Martin Feldstein shows that the credit for foreign taxes paid does not induce U.S. firms to expand their foreign direct investment (FDI) enough so that the return on FDI to the United States is less than the return on the displaced domestic investment. Feldstein argues that a typical marginal investment overseas (which has the same net return to an American multinational parent as an alternative marginal domestic investment) actually generates a higher return for the United States than would the domestic investment it displaces. In order to maximize the present value of U.S. national income, one would not replace the current foreign tax credit with a deduction for foreign taxes. Instead, one would move in the opposite direction, encouraging more FDI in general, and investments that employ substantial foreign debt per dollar of U.S. capital in particular.

Joosung Jun modifies conventional cost-of-capital measures to incorporate the impact of international tax rules. He finds that corporate taxation of foreign investment causes U.S. firms operating in major foreign markets to face, on average, about 20 percent higher costs of capital than do domestic firms in the United States. Further, U.S. firms very likely face higher costs of capital than do local firms in foreign markets. U.S. firms operating in foreign markets also may have cost-of-capital disadvantages vis-à-vis firms from third countries, in part because the U.S. tax system is not integrated and in part because U.S. tax deferral and foreign tax credit calculation rules are so strict.

1. More-technical papers appear in the companion volume edited by Feldstein, Hines, and Hubbard (1995) and in earlier volumes edited by Razin and Slemrod (1990) and Giovannini, Hubbard, and Slemrod (1993).

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Roger Gordon and Jeffrey MacKie-Mason examine possible explanations of why industrial countries tax the overseas income of their domestic multinational firms in the ways that they do. Many economists argue that it is inefficient to use corporate income taxes to raise revenue in open economies. If capital is internationally mobile, the burden of corporate taxes falls largely on other immobile factors (such as labor), and the tax system would be more efficient if these other factors were instead taxed directly. Not only do governments use corporate taxes, however, but corporate tax rates are also roughly comparable with top individual tax rates. Some theories predict that multinationals based in countries with residence-based tax systems should not invest in countries with low corporate tax rates, since those multinationals must pay sizable surtaxes when they repatriate their profits. This tax obligation imposes on these multinationals a competitive disadvantage, yet there is a significant amount of such FDI. Gordon and MacKie-Mason suggest that the abilities of firms to shift income (through aggressive transfer pricing) may explain the use of corporate income taxes, as well as the observed pattern of FDI. Countries may use corporate taxes as backstops to labor income taxes in order to discourage individuals from converting their labor incomes into otherwise-untaxed corporate income. The authors explore how those taxes might be modified to deal with cross-border income shifting.

Andrew Lyon and Gerald Silverstein examine some of the ways that U.S.-based multinational corporations may be affected by the corporate alternative minimum tax (AMT). In 1990, more than half of all the foreign-source income was earned by corporations subject to the AMT. Consequently, when U.S. firms plan their foreign activities, the tax incentives created by the AMT may be at least as important as those created by the regular U.S. corporate tax. The AMT creates a relative incentive for AMT firms to invest abroad rather than in the United States, and the AMT offers a temporary timing opportunity that allows repatriation of income from abroad at a lower cost than if the firm were subject to the rules of the regular U.S. tax system. These two different incentives have an ambiguous effect on U.S. domestic investment overall, if repatriated income is retained by the parent corporation in the United States. The AMT may provide an opportunity for firms to repatriate income from certain foreign locations with poor reinvestment opportunities, and at the same time to reinvest funds abroad in alternative foreign locations that have better investment opportunities. There appears to be an ambiguous net effect of these two incentives on the total volume of capital invested outside the United States.

James Hines asks first whether R&D activity by multinational firms is sensitive to local tax conditions, and second whether imported technology and R&D are complements or substitutes. He finds that R&D responds to local tax rates, and that it is a substitute for imported technology. Firms appear to react to high royalty tax rates by paying fewer royalties and performing additional R&D locally. To the extent that royalty payments reflect actual technology transfer (rather than adept accounting practices), the behavior of multinational firms suggests that local R&D is a substitute for imported technology.

Rosanne Altshuler, Scott Newlon, and William Randolph recognize that repatriation taxes on dividends may vary over time, providing firms with incentives to time repatriations so that they occur in years when repatriation tax rates are relatively low. The authors use information about cross-country differences in tax rates to distinguish the effects on dividend repatriations of permanent tax changes (as typically occur when statutory tax rates change) from the effects of transitory tax changes. Using data from U.S. tax returns for a large sample of U.S. corporations and their foreign subsidiaries, the authors find that permanent tax changes have much smaller effects than do the transitory tax changes. This finding suggests that repatriation taxes *do* affect dividend repatriation decisions, but only to the extent that taxes vary over time.

Jason Cummins and R. Glenn Hubbard use panel data on FDI by subsidiaries of U.S. multinational firms to measure the effect of taxation on FDI. The results cast significant doubt on the simplest notion that taxes do not influence U.S. firms' overseas investment decisions. Taxes appear to influence FDI in precisely the ways indicated by traditional neoclassical economic models of investment behavior. Specifically, it appears that the annual rate of overseas investment falls by 1–2 percentage points for each percentage point rise in the cost of capital for outbound FDI. This effect, which is of a magnitude similar to those recently estimated for domestic investment by U.S. and European firms, implies that changes in foreign corporate tax rates and depreciation rules, or in the foreign tax credit status of parent firms, significantly influence overseas investment by U.S. subsidiaries.

Kenneth Froot and James Hines examine the impact of the change in the U.S. interest allocation rules that followed passage of the Tax Reform Act of 1986. The 1986 act significantly limited the tax deductibility of the U.S. interest expenses of certain American multinational corporations. This tax change increased the tax liabilities of certain American multinationals and made additional borrowing more expensive for these firms. Froot and Hines find that the change in interest allocation rules discouraged borrowing and new investments. Firms that were unable to deduct all of their interest expenses against their U.S. tax liabilities issued 4.2 percent less debt (measured as a fraction of total firm assets) and invested 3.5 percent less in property, plant, and equipment during 1986–91 than other firms did. This is consistent with other evidence that suggests that the Tax Reform Act of 1986 significantly raised the borrowing costs of some American multinational firms.

Jason Cummins, Trevor Harris, and Kevin Hassett analyze the two accounting regimes that govern reporting practices in most developed countries. "One-book" countries, such as Germany, use their tax books as the basis for financial reporting. "Two-book" countries, including the United States, keep tax and financial reporting books largely separate. Firms in one-book countries may be reluctant to claim certain tax benefits if reductions in their taxable incomes can

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be misinterpreted by financial market participants as signals of lower profitability. The authors' estimates suggest that the interaction of tax systems and accounting regimes significantly influences domestic investment patterns, both within and across countries.

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Appendix

James R. Hines, Jr., and R. Glenn Hubbard

Most of the papers in this volume examine the impact of U.S. tax rules on the behavior of multinational corporations. Since reference to certain rather detailed aspects of the U.S. tax system occurs repeatedly in these papers, this appendix describes two of the major features of U.S. taxation of its resident multinational companies: how firms can defer U.S. taxation of certain foreign earnings, and how to determine whether an American company has "excess foreign tax credits."

The United States taxes income on a residence basis, meaning that American corporations and individuals owe taxes to the U.S. government on all their worldwide income, whether earned inside or outside the United States. In order to avoid subjecting American multinationals to double taxation, U.S. law permits firms to claim foreign tax credits for income taxes (and related taxes) paid to foreign governments.[1] The U.S. corporate tax rate is currently 35 percent. Under the foreign tax credit system, a U.S. corporation that earns $100 in a foreign country with a 15 percent tax rate pays a tax of $15 to the foreign government and $20 to the U.S. government, since its U.S. corporate tax liability of $35 (35 percent of $100) is reduced to $20 by the foreign tax credit of $15.

Deferral of U.S. Taxation

Under U.S. law, Americans must pay tax to the U.S. government on their worldwide incomes, except for a certain category of foreign income that is

1. The U.S. government is not alone in taxing the worldwide income of its resident companies while permitting firms to claim foreign tax credits. Other countries with such systems include Canada, Italy, Japan, Norway, and the United Kingdom. Under U.S. law, firms may claim foreign tax credits for taxes paid by foreign affiliates of which they own at least 10 percent, and only those taxes that qualify as income taxes are creditable.

temporarily excluded from U.S. taxation. The excluded category is the unrepatriated portion of the profits earned by foreign subsidiaries; taxpayers are permitted to defer any U.S. tax liabilities on those profits until those profits are paid as dividends to the United States.[2] This deferral is available only on the active business profits of American-owned foreign affiliates that are separately incorporated as subsidiaries in foreign countries. The profits of unincorporated foreign businesses, such as those of U.S.-owned branch banks in other countries, are taxed immediately by the United States.

To illustrate deferral, consider the case of a U.S.-owned subsidiary that earns \$500 in a foreign country with a 10 percent tax rate. This subsidiary pays taxes of \$50 to the foreign country (10 percent of \$500), and might remit \$100 in dividends to its parent U.S. company, using the remaining \$350 (\$500 − \$50 of taxes − \$100 of dividends) to reinvest in its own foreign operations. The U.S. parent firm must then pay U.S. taxes based on the \$100 of dividends it receives (and is eligible to claim a foreign tax credit for the foreign income taxes its subsidiary paid on the \$100). But the U.S. firm is not required to pay U.S. taxes on any part of the \$350 that the subsidiary earns abroad and does not remit to its parent U.S. company. If, however, the subsidiary were to pay a dividend of \$350 the following year, the firm would then be required to pay U.S. tax on that amount (after proper allowance for foreign tax credits).

U.S. tax law contains provisions designed to prevent American firms from delaying the repatriation of lightly taxed foreign earnings. These tax provisions apply to controlled foreign corporations, which are foreign corporations owned at least 50 percent by U.S. corporations or individuals holding stakes of at least 10 percent each. Under the subpart F provisions of U.S. law, certain types of the foreign income of controlled foreign corporations are "deemed distributed" and are therefore immediately taxable by the United States, even if not repatriated as dividend payments to American parent firms. This subpart F income can be from passive investments (such as interest and dividends received from investments in securities), foreign base company income (which arises from using a foreign affiliate as a conduit for certain types of international transactions), income that is invested in U.S. property, money used offshore to insure risks in the United States, and money used to pay bribes to foreign government officials. American firms with foreign subsidiaries that earn profits through most types of active business operations and that subsequently reinvest those profits in active lines of business are not subject to the subpart F rules, and are therefore able to defer U.S. tax liability on their foreign profits until they choose to remit dividends at a later date.

2. Deferral of home-country taxation of the unrepatriated profits of foreign subsidiaries is a common feature of systems that tax foreign incomes. Other countries that permit this kind of deferral include Canada, Denmark, France, Germany, Japan, Norway, Pakistan, and the United Kingdom.

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Excess Foreign Tax Credits

The U.S. government permits American firms to claim foreign tax credits, with the understanding that this policy reduces the tax revenue collected by the United States on any given amount of foreign-source income. The foreign tax credit is intended to reduce the problems created by international double taxation. Consequently, the U.S. government is careful to design the foreign tax credit in a way that prevents American firms from using foreign tax credits to reduce U.S. tax liabilities that arise from profits earned *within* the United States.

The government imposes limits on the foreign tax credits that U.S. firms can claim; a firm's foreign tax credit limit equals the U.S. tax liability generated by the firm's foreign-source income. For example, with a U.S. tax rate of 35 percent, an American firm with $200 of foreign income faces a foreign tax credit limit of $70 (35 percent of $200). If the firm pays foreign income taxes of less than $70, then the firm would be entitled to claim foreign tax credits for all of its foreign taxes paid. If, however, the firm pays $95 of foreign taxes, it would be permitted to claim no more than $70 of foreign tax credits.

Firms described by this second case, in which foreign tax payments exceed the foreign tax credit limit, are said to have excess foreign tax credits; the excess foreign tax credits represent the portion of their foreign tax payments that exceeds the U.S. tax liabilities generated by their foreign incomes. Firms described by the first case, in which foreign tax payments are less than the foreign tax credit limit, are said to have excess foreign tax limitation.[3] Under U.S. law, firms can, under some circumstances, use excess foreign tax credits in one year to reduce their tax obligations for other years. Firms are allowed to apply any excess foreign tax credits against their U.S. tax obligations for up to the two previous years, and to recalculate their tax returns for those years while choosing when to apply the excess foreign tax credits. If a firm prefers, it can instead apply its excess foreign tax credits against U.S. tax liabilities on foreign income in up to the following five years.[4]

In practice, the calculation of the foreign tax credit limit entails many complications not addressed here. One major feature of the calculation should, however, be noted: U.S. law requires firms to use all of their worldwide foreign

3. An equivalent phrase used to describe firms with excess foreign tax limitation is to say that they have deficit foreign tax credits. These two phrases are used interchangeably.

4. Foreign tax credits are not adjusted for inflation, so firms generally find them to be the most valuable if claimed as soon as possible. Barring unusual circumstances, firms apply their foreign tax credits against future years only when they are unable to apply them against either of the previous two years. The most common reason for inability to apply excess foreign tax credits is that a firm already has excess foreign credits in those two years.

income to calculate the foreign tax credit limit. Firms then have excess foreign tax credits if the sum of their worldwide foreign income tax payments exceed this limit.[5] This procedure is known as worldwide averaging.

5. Not all countries that grant foreign tax credits use worldwide averaging. For example, while Japan uses worldwide averaging, the United Kingdom requires its firms to calculate foreign tax credits on an activity-by-activity basis. The United States used to require firms to calculate separate foreign tax credit limits for each country to which taxes were paid; the current system of worldwide averaging was introduced in the mid-1970s.

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