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on
International Tax Issues

Mr. Chairman and Members of the Committee, I am Jane Gravelle, a Senior Specialist in Economic Policy in the Congressional Research Service of the Library of Congress. I would like to thank you for the invitation to appear before you today to discuss international tax issues..

A striking feature of the modern U.S. economy is its growing openness—its increased integration with the rest of the world. The attention of tax policymakers has recently been focused on the growing participation of U.S. firms in the international economy.

Many proposals for tax revision argue that our corporate tax system should be revised to improve our "international competitiveness." Among proposals advanced for this purpose is moving to a territorial, or source-based, tax, which would exempt foreign source income of U.S. firms. Arguments for this revision are sometimes accompanied with an appeal to a concept termed "capital import neutrality." Related proposals include enacting another repatriation holiday and cutting the corporate tax rate, possibly with accompanying base broadening.

Proposals for a Territorial Tax System[1]

The current U.S. system for taxing international business is a hybrid of worldwide and territorial principles. In part the system is based on a residence principle, applying U.S. taxes on a worldwide basis to U.S. firms while granting foreign tax credits, to alleviate double taxation. The system, however, also permits U.S. firms to defer the tax on profits earned by foreign subsidiaries until dividends are paid to the U.S. parent. Foreign tax credits are limited to the U.S. tax imposed on foreign source income. This limit is applied on an overall basis and permits cross-crediting, where unused foreign taxes generated in one country or on one kind of investment can offset U.S. tax due on income from low-tax countries. Deferral means that the U.S. system, while generally residence-based, has elements of a territorial system. It also encourages firms to conduct activities and retain earnings abroad.

Although the particular details could vary with different proposals, a territorial tax would exempt the earnings of foreign subsidiaries from U.S. tax. International tax policy could move in the direction of a worldwide tax as well, by eliminating deferral. The President's FY2012 budget proposals would move in this direction. These proposals would not fully eliminate deferral but would disallow some parent company deductions to the extent taxes on foreign source income are deferred, and restrict foreign tax credits related to deferred income. Both a territorial tax and eliminating deferral would eliminate the incentive to retain earnings abroad.

Concepts of Competitiveness, Efficiency and Optimality

Although the term competitiveness has been invoked in the debate about U.S. policy in a global economy, it is not *countries* that are competitive, it is *companies* that are. A company generally thinks of itself as competitive if it can produce at the same cost as, or a lower cost than, other firms. But a country's firms cannot be competitive in all areas. Indeed, even if firms in a

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[1] The issues discussed in this section and the following two sections are discussed in more detail in CRS Report RL31145, Reform of U.S. International Taxation: Alternatives, by Jane G. Gravelle.

country are more productive than firms in all other countries in every respect, a country would still tend to produce those goods in which its relative advantage is greatest and trade with other countries for the goods they do not have a relative advantage in productivity. The other countries need to produce goods with their resources as well. This notion is called comparative advantage, and it is an important concept in economic theory, dating from the early 19th century.

In sum, companies compete, and countries trade. In the economic analysis of tax policy, including tax policy and its effect on the international allocation of capital, the issues are generally framed around concepts of efficiency, neutrality, and optimal policies rather than notions of competitiveness. These terms can mean the same thing, or they can be slightly different. Neutrality generally refers to provisions that do not alter the allocation of investment from that which would occur without taxes. Efficiency refers to the allocating capital to those uses that yield the highest social (or pre-tax) return, and it maximizes world welfare. When markets are operating competitively, a neutral tax policy will also be an efficient policy, since it will maintain the efficient allocation that would occur without taxes. Moreover, even when there are market imperfections, neutrality may still be the policy most likely to be efficient, given the difficulty in identifying and measuring market imperfections.

Optimal policy differs from efficiency in that it usually refers to a particular agent or actor choosing a policy that maximizes his or her own welfare. A country can also choose a policy that leads to the greatest welfare for its own citizens, even if that policy distorts the allocation of capital (is not neutral) and leads to less efficient worldwide production. The optimal policy from the perspective of a country, in other words, may not be the most efficient in terms of the worldwide allocation of capital, and may not be the optimal policy from the perspective of world economic welfare.

Concepts, or guidelines, are discussed in the formulation of international policy. Two concepts that relate to these goals of efficiency or optimality are capital export neutrality and national neutrality. Capital export neutrality requires a country to apply the same tax rate to its firms' investments, regardless of where they are located, and is embodied in a residence-based tax system. National neutrality requires that the nation's total return on investment, including both that nation's taxes and its firms' profits, is equal in each jurisdiction, foreign and domestic. This form of neutrality is obtained by taxing foreign-source income and allowing a deduction for foreign taxes. There is also an optimizing rule for choosing the tax rate on inbound investment, which depends on how responsive that investment inflow is to the return.

A third concept, capital import neutrality, is achieved with source-based or territorial taxation. This approach, however, will result in higher returns in low-tax countries. As a result, capital will flow out of the high-tax country, raising its return and lowering the wages of the workers in that country and into the low-tax country, lowering its return and raising the wages of the workers in that country. Although capital import neutrality appears to be fair by imposing the same taxes on firms operating in a particular country, it is not neutral because firms make choices based not on the options facing other country's firms but on their on returns to investment in different location. Hence, a territorial tax is not neutral or efficient.

In sum, according to these longstanding measures of neutrality and efficiency, capital export neutrality is appropriate for maximizing world output, national neutrality is appropriate for maximizing a nation's welfare, and capital import "neutrality" is not neutral at all.

Although this discussion focuses on the allocation of capital, another consequence of the choice of tax regime is the ability to artificially shift profits (without necessarily altering economic activities) from high-tax to low-tax countries, which reduces tax revenues in the high-tax country. Profit shifting can occur in territorial tax systems, depending on the ability of the tax authorities to police it, and it can occur in the U.S. system because of deferral. Considerable evidence exists to indicate profit shifting occurs.[2]

[2] This evidence is discussed in CRS Report R4063, *Tax Havens: International Tax Evasion and Avoidance*, by Jane G. Gravelle.

Is Capital Export Neutrality Obsolete?

Recently, arguments have been made that these concepts are outmoded because firms can alter their nationality. That is, these concepts are based on the notion that U.S. firms are constrained by U.S. tax rules. If firms can shift their nationality or if investors can shift their portfolios to foreign firms, capital export neutrality cannot be achieved by a country.

Firms could potentially change their nationality by moving their headquarters abroad (termed "inverting"), by merging with foreign firms, or by originally incorporating abroad. In 2004, however, Congress enacted anti-inversion rules which continue to treat these firms as U.S. firms and this approach seems to be working effectively.[3] Inverted firms, such as Transocean, owner of the Deepwater Horizon drilling operation in the Gulf of Mexico, generally inverted prior to 2004. Other stricter rules could also be devised, including a facts and circumstances determination of management control. Thus, existing or potential provisions can be used to prevent this action even if further movement towards a residence-based tax (such as eliminating or restricting deferral) occurred. Recent evidence has also suggested that firm's headquarters choices are not affected significantly by taxes.[4]

International mergers seem less of a concern because there are many serious consequences to a merger that may outweigh tax considerations. It is also, however, possible to devise rules that prevent or limit tax motivated mergers and rules of this nature (limiting certain tax benefits for a firm if there is at least 60% continuing ownership for ten years) were adopted in 2004 as well.

New start-up firms are not likely to be an important avenue for shifting nationality. The challenges that a new U.S. firm face are significant and success is more likely in a familiar

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[3] The American Jobs Creation Act of 2004, P. L. 108-357.
[4] Kimberly Clausing, "Should Tax Policy Target Multinational Firm's Headquarters?" *National Tax Journal*, Vol. 63, No. 4, Part 2, December 2010.

environment. Moreover, at the point when the firm has an initial public offering, it would likely be more successful with stock offered in a U.S. firm governed by U.S. rules and regulations. Preliminary research (whose specific results are not yet available to be cited) has also suggested that foreign IPOs for U.S. entrepreneurs are rare.[5]

Rather than U.S. firms or potential U.S. firms incorporating abroad, another avenue that is sometimes cited as a concern for achieving capital export neutrality, is that U.S. citizens can invest directly in foreign firms. This argument appeared to gain currency in recent years as U.S. portfolio investment abroad increased, although there is a significant home bias, with about 80% of U.S. portfolios invested in U.S. firms. Although portfolio investment has increased significantly, it is probably related to the greater ease with which foreign stocks can be purchased. Supporting the view that the major motive for this expansion of portfolio investment is portfolio diversification, most stocks held in foreign firms are in firms in developed countries with similar tax rates to those of the U.S., not firms in low tax countries. Since portfolio investors are concerned with the overall return (governed by overall tax rules) and not the details of a country's foreign tax regime, this behavior is unlikely to reflect a desire to avoid U.S. tax on foreign source income.

Policy makers might need to remain vigilant about the possibility of shifting the location of firms, if a movement further towards a residential tax system is contemplated. While moving to a territorial tax would reduce any existing incentives to headquarter abroad, however, it is not clear that this issue would be important enough, with respect to revenues, to overcome the increased incentive for profit shifting, since it is likely easier for firms to shift profits than to shift headquarters.

[5]Eric Allen (Ph.D. Candidate, UC-Berkeley) & Susan Morse (UC-Hastings), Firm Incorporation Outside the U.S.: No Exodus Yet, This paper was referred to on a well known tax professor blog and presented at a recent tax conference. See http://taxprof.typepad.com/taxprof_blog/conferences/.

Repatriation and a Repatriation Holiday[6]

One aspect of our deferral system is that it encourages firms to retain profits abroad if they are in circumstances where adequate foreign tax credits do not exist to offset U.S. tax. This incentive is somewhat constrained because if firms pay taxes in the future they will pay them with interest and because funds may be needed to pay dividends. This incentive could, however, be eliminated either through a territorial tax or through a repeal of deferral.

In 2004, firms were allowed a repatriation holiday that permitted them to repatriate while excluding 85% of dividends from the tax.[7] The purpose of this holiday was to make funds available for investment and to hire workers. Most evidence, however, suggested that funds were used to pay shareholders; evidence also suggested that the holiday increased the tendency of firms to retain profits abroad in later years, possibly in anticipation of another holiday.

There has been some discussion of another holiday to provide funds to increase investment and hiring of workers, although the arguments are perhaps less compelling currently because of the large amount of liquid funds already held by corporations. Granting another holiday might also reinforce firms' beliefs that they will periodically be allowed to repatriate at a low tax cost, and might further encourage future retentions abroad. It is not clear, in any case, how important the repatriation is to financing investment given the fungibility of money. If another repatriation holiday is considered, it might be more effective if the benefit is tied to increases in economic activity such as investment, hiring workers, or research expenditures.

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[6] Issues discussed in this section are discussed in further detail in CRS Report R40178, *Tax Cuts on Repatriation Earnings as an Economic Stimulus: An Economic Analysis*, by Donald J. Marples and Jane G. Gravelle.
[7] The American Jobs Creation Act of 2004, P. L. 108-357.

Reducing Corporate Tax Rates[8]

Advocates of cutting corporate tax rates frequently make their argument based on the higher statutory rate in the United States as compared with the rest of the world; they argue that cutting corporate taxes would induce large investment flows into the United States, which would create jobs or expand the taxable income base enough to raise revenue. Some proposals for rate reductions support a revenue neutral tax reduction which also expands the tax base, given the current pressures on the deficit. Others have urged on one hand, a revenue raising reform, and, on the other, setting deficit concerns aside.

Is the U.S. tax rate higher than the rest of the world, and what does that difference imply for tax policy? The answer depends, in part, on which tax rates are being compared. Although the U.S. statutory tax rate is higher, the average effective rate is about the same, and the marginal rate on new investment is only slightly higher than corresponding rates in other countries. The statutory rate differential is relevant for international profit shifting; effective rates are more relevant for firms' investment levels. The differential in statutory rates is reduced when tax rates in the rest of the world are weighted to reflect the size of countries' economies and further reduced when the production activities deduction is included.

For outbound capital (capital owned by U.S. firms but invested abroad), a corporate rate cut acts in the opposite direction from a territorial tax, because it discourages the flow of capital abroad, while a territorial tax encourages the flow of capital out of the United States. A corporate rate cut would increase inbound capital, although the gains to revenue would be uncertain since a rate cut, while collecting taxes on induced inflows, reduces taxes collected on existing investments.

Regardless of tax differentials, could a U.S. rate cut lead to significant economic gains and revenue feedbacks? Because of the factors that constrain capital flows, estimates for a rate cut

[8] This section summarizes research contained in CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

from 35% to 25% suggest a modest positive effect on wages and output: an eventual one-time increase of less than two-tenths of 1% of output. Most of this output gain is not an increase in national income, because returns to capital imported from abroad belong to foreigners and the returns to U.S. investment abroad that comes back to the United States are already owned by U.S. firms. The gain in income is estimated at about a tenth of the output gain, 2/100 of 1%.

The revenue cost of such a rate cut, with no base broadening, is estimated at between $1.2 trillion and $1.5 trillion over the next 10 years. Revenue feedback effects from increased investment inflows are estimated to reduce those revenue costs by 5%-6%. Reductions in profit shifting could have larger effects, but even if profit shifting disappeared entirely, it would not likely offset revenue losses. In any case, it seems unlikely that a rate cut to 25% would significantly reduce profit shifting given these transactions are relatively costless, largely constrained only by enforcement, and significant tax differentials would remain.[9]

These results also suggest that the gains to output in the United States from ending deferral and the losses from moving to a territorial tax would be small as well, since these policies have smaller effects than the corporate rate cut. They might have more important consequences for profit shifting.

Both output gains and revenue offsets would be reduced if other countries responded to a U.S. rate cut by reducing their own taxes. Evidence suggests that the U.S. rate cut in the Tax Reform Act of 1986 might have triggered rate cuts in other countries. Output gains might also be reduced since tax rate reductions increase the cost of debt finance which is likely more mobile.

It is difficult, although not impossible, to design a reform to lower the corporate tax rate by 10 percentage points that is revenue neutral in the long run. Standard tax expenditures do not appear adequate for this purpose. Eliminating one of the largest provisions, accelerated

[9] A recent news story explained how Google not only shifted its European operations to Ireland, but also took measures to shift profits out of Ireland, with a 12.5% rate, to Bermuda, with a 0% rate. Jesse Drucker, "Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes," *Bloomberg*, Oct. 21, 2010, posted at http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

depreciation, gains much more revenue in the short run than in the long run, and a revenue-neutral change would increase the cost of capital. The other major source of broadening is increasing the taxation of foreign source income by ending deferral and restricting foreign tax credits, and limiting interest deductibility. The former moves in opposite direction to a territorial tax, and the latter could cause reductions in capital flows into the United States if debt is significantly more mobile than equity. Rate cuts could also be financed by increasing shareholder level taxes on dividends and capital gains.