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Subject Tax Distortion and Avoidance in the U.S. System for Taxing MNCs

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I. U.S. Policy Toward MNCs: Theory and Practice

At the most general level, U.S. policy toward the operations of multinational corporations has for years been described as one of neutrality -- a general opposition to government action, at home or abroad, that distorts the free flow of capital or technology.[1] As regards tax policy, the attempted implementation of neutrality has generated at least two, more specific principles: "national treatment," or non-discrimination between firms on the basis of national ownership, and "capital export neutrality." The first is designed to assure equality of access to markets in the United States for all firms, and to promote that equality for U.S. MNCs operating abroad. Capital export neutrality (CEN) attempts to neutralize the impact of different tax systems on the flow of direct investment capital from the United States -- by making the marginal tax rate on foreign profits equal to the U.S. tax rate. In an ideal world, CEN would be achieved by a variant of the present U.S. practice of providing a tax credit for foreign taxes.[2]

1. See Graham and Krugman (1989), chapter 6, for a consideration of recent U.S. policy statements and commitments; these include policy declarations by the Carter and Reagan administrations, adherence to the neutrality principle in the OECD Code on the Liberalization of Capital Movements, and numerous bilateral investment treaties.
2. Other, competing principles that are sometimes debated as alternatives to CEN are: "capital import neutrality," sometimes called a "territorial" system, where taxes do not distort the equality of before-tax marginal returns between foreign- and domestically-owned firms in the *same* country; "national neutrality," where a country's marginal return, including taxes, is equalized between domestically-located and foreign located firms (an equality achieved in principle by a *deduction* for foreign taxes on domestic tax returns). For more details see Caves (1982), chapter 8, or Hufbauer (1992), chapter 3.

In the real world, however, the goal of capital export neutrality is probably far from being attained. In the first place, important deviations have been caused over the years by the Treasury's attempts to protect the tax base; most important, in order to prevent high tax rates abroad from siphoning off U.S. tax revenue, foreign tax credits for a given firm are limited to the amount of U.S. tax that would otherwise be due on the foreign profits. As the United States has evolved into a low tax jurisdiction during the 1980s, excess tax credits have grown substantially; besides the probable deviations from capital export neutrality, Hufbauer (1992) argues that this development has also caused serious distortions in the generation and spread of new technology. (See section IV, below, for a fuller discussion of Hufbauer's position.)

A second significant deviation from CEN is the longstanding practice of *deferral*: the postponement of U.S. taxes on profits of U.S.-owned subsidiaries abroad until dividends are repatriated to the parent. The distortion from CEN is obvious -- in favor of investment abroad -- and the policy has no rationale.[3]

Once a deviation from neutrality exists, incentives arise to shift profits to the jurisdiction with the lowest tax rate (taking account, of course, of the tax savings implied by deferral). One, thus, enters the world of transfer pricing -- practices which, interpreted broadly, can include, in addition to the garden variety juggling of the prices of imports and exports, the manipulation of interest payments and charges for R&D and administrative expenses. Transfer pricing abuses can also be

3. A short history of U.S. tax policy toward direct investment, showing the slow, evolutionary development of the basic concepts, helps one understand why the real world is so far from the ideal. A good short history through the mid-1970s is provided in Bergsten, Horst and Moran (1978), pp. 165 ff. For later developments, see Hufbauer (1992).

motivated in the United States by foreign-owned firms from countries where capital export neutrality is not practiced; in particular, if a country follows a territorial system, where remitted dividends are not taxed by the home country, there are strong incentives to minimize U.S. taxes by any means possible.

Other deviations from capital export neutrality in the U.S. system include the application of taxes or incentives that are not offered equally to domestic and foreign subsidiaries of U.S firms; an important case in past years was the limitation of the investment tax credit to domestically located subsidiaries.

Given the present state of our international tax system, it is likely that problems of tax avoidance and distortions to capital export neutrality will long be with us. Although Treasury's attempts to limit tax avoidance by U.S.-owned firms have been virtually unceasing, most recent media attention has focused on tax avoidance by foreign-owned subsidiaries in the United States. One of a number of reasons for this attention was President Clinton's campaign proposal to increase tax collections on these firms by $45 billion over 4 years. Another is a draft bill known as the Rostenkowski-Gradison Bill (H.R. 5270), a key part of which shares the President's goal and proposes some Draconian methods to achieve it. A totally different approach, which faces the problems of tax avoidance and distortions to CEN with much more realism than H.R. 5270, is the subject of a recent book by Gary Hufbauer (1992). This study is of special interest because, as noted above, it addresses the promotion of competitiveness in addition to capital export neutrality.

II. The Rostenkowski-Gradison Bill: H.R. 5270

This bill was introduced last May and, despite assurances that its purpose was mainly to elicit discussion, provoked a storm of protest from foreign governments and foreign-MNCs operating in the United States; despite one goal of the bill to provide approximately $11 billion in tax relief to U.S. subsidiaries abroad (by more flexibility in interest allocation and other rules), because of a provision to abolish deferral on future foreign profits, the support of U.S. MNCs was lukewarm at best.

In terms of major departures from current practice outlined in section I, above, there are three major provisons in the Rostenkowski-Gradison Bill:

Proposed Minimum Profitability Test for Foreign-owned Subs in the U.S.

Basically, this provision would establish a minimum tax for foreign-owned subsidiaries in the United States irrespective of their true profit rates -- something of an overreaction to the vexation of the suspiciously low declared profits by these subsidiaries. A pretax profit rate (on gross receipts) would be calculated for U.S. domestic firms in a given SIC industry; any foreign-owned subsidiary in that industry would be taxed on an imputed profit rate equal to at least 75 percent of the calculated domestic profit rate. At a minimum, this violates the non-discrimination pillar of our direct investment policy (embodied in many bilateral investment treaties).[4]

4. This is the Treasury's position, as was made clear by Assistant Secretary Goldberg (1992) in his submission to the Committee. The most obvious evidence of discrimination is that U.S. businesses would not be subject to the minimum tax.

The staff of the Joint Committee on Taxation (1992), pp. 51-52, tries, rather disingenuously its seems, to frame a justification on the grounds of creating a test for reasonable transfer prices under section

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Abolishment of Deferral and A Provision to Override Certain Treaties

As attempted many times in the past, the second key change wrought by the bill would be the abolition of deferral.

The third major departure would be the cancelling in certain cases of treaty benefits for foreign-owned subsidiaires in the United States. In somewhat mystical language (at present), a foreign subsidiary would be barred from obtaining any benefits under a tax treaty if the "income would be taxed at a significantly lower rate in the treaty country than similar income arising from sources within the foreign country derived by residents of the foreign country."[5] Nobody at this point can quite determine how this provision would be interpreted. This proposal has elicited such comments as the United States will be looked on as a "renegade;" "We act like we're the only country in the world;" "If Americans want to play rough, we can play rough, too." [6]

III. Congressional and Presidential Revenue Goals

Supporters of H.R. 5270 seem to be motivated by the belief that large amounts of taxes are being wrongfully diverted from the U.S. Treasury by shady transfer pricing practices. The most outlandish

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482 of the IRS Code. Section 482 allows certain market-based tests to be established to determine whether a given transfer price is truly an arm's length price. The Committee staff claims that the proposed minimum profit rate is just a test for non-arm's-length transfer pricing.

5. Unbelievable as it may seem, this language from Barbara Kirchheimer (1992), p. 1304, is more clear that the Staff report's.
6. Kirchheimer (1992), p.1304.

estimate, $30 billion or more in annual lost taxes, came in hearings held by Rep. Pickle's Subcommittee on Oversight of the Ways and Means Committee .[7] Given this estimate, the original proposal by the Clinton campaign to increase tax collections from foreign-owned subsidiaries by slightly over $11 billion a year seems reasonable, even modest. Unfortunately, there is no empirical support for either of these estimates.

Eileen Mauskopf (1992) recently examined the issue in detail and concluded that the best estimate of the *upper bound* of lost tax revenues is approximately $3 billion per year; this latter estimate comes from the only scientifically defensible study of the subject, that Grubert, Goodspeed, and Swenson (1991), using 1987 IRS returns.[8] This study finds that it can explain about 50 percent of the difference in profit rates between foreign-owned and domestically-owned firms in the United States by factors unrelated to tax avoidance: e.g. the age of the subsidiary, whether its assets had been recently revalued to market prices, and variations in the exchange rate (because foreign-owned firms have higher import ratios). No significant effects were found for the country of ownership, debt/asset ratios, or variations in the cost of equity capital. If one attributes all of the 50 percent unexplained difference in profit rates to transfer pricing abuses, the estimate of $3 billion in lost tax revenues is the result.

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7. See Eileen Mauskopf (1992) for an excellent analysis of this and other estimates. This estimate assumes that foreign companies "should" earn at least 9 percent on their assets in the United States; the shortfall of actual taxes from those estimated on the basis of the 9 percent return was $30.8 billion in 1988 and $37.6 billion in 1989.
8. Since declared profits of foreign-owned firms in the United States have dropped substantially since 1987 (because of extraordinary losses in a variety of industries and the general cyclical decline), it is likely that today the upper bound would be below $3 billion.

IV. Hufbauer's Blueprint for Reform

In his recent book, Hufbauer addresses virtually all the distortions and weaknesses in the present system noted in section I. Although his proposals admittedly could not be implemented without extensive consultation and treaty revision, they are crafted with full appreciation of political and economic realities, as well as a keen understanding of the theory of taxation; for these reasons, it is instructive to sketch how Hufbauer faces and proposes to overcome the failings of the present system.

Hufbauer is concerned primarily with the adverse impact of the present tax system on the U.S. production of technology and high-tech goods.[9] He shows, in particular, how the limitation of foreign tax credits, in today's world of *excess* tax credits, offers tax incentives to export both technology and the production of technologically-advanced goods. As an example, he notes that royalties from technology sold or leased to a non-affiliated foreign firm is usually taxed little or not at all by either the U.S. or foreign jurisdictions. Most foreign jurisdictions tax such royalties, if at all, at a low withholding rate of around 10 percent; moreover, because of the pooling of income worldwide in the calculation of tax credits and their limitations, this royalty can absorb enough excess tax credits from elsewhere in the system to avoid U.S. taxation completely.

Hufbauer also shows how recently developed "allocation rules" for an MNC's worldwide R&D and administrative expenditures, when combined with

9. It is too complicated to explore here, but Hufbauer argues that, despite its distortions, the present tax system probably fails by only a little to attain capital export neutrality. He argues that, given the universal deductibility of interest expenses, the free flow of debt capital will compensate for distortions in the flow of equity capital.

the existence of excess tax credits, cause a disincentive for R&D and "headquarter" expenditures in the United States. These allocation rules are one Treasury attempt to prevent MNCs from using such expenses to shift profits to low tax jurisdictions. The IRS has adopted rules that allocate a significant part of these expenses, more or less in line with sales, to the various operations in a multinational's corporate family. The result is to increase the U.S. taxes of the MNC and, probably, to leave foreign taxes unchanged (because R&D done in the United States is usually not deductible on foreign tax returns).[10]

Hufbauer's solution, although controversial, addresses all the weaknesses and strengths of the present system. First, in view of what he sees as the impossibility of harmonizing the principle of CEN with the inevitability of limitations on foreign tax credits, he advocates an abandonment of tax credits, i.e. the abandonment of the principle of capital export neutrality, itself. In place of the existing system, he would institute a territorial system (see footnote 2, above). The actual production of goods and services would be taxed (only) by the country in which the production occurs (non-discriminatorily, one would hope, so as to achieve capital *import* neutrality); thus, the United States would give up the taxation of the profits of its foreign subsidiaries. On the other

10. In the world of excess tax credits, U.S. taxes are likely to be increased in a number of circumstances by the R&D allocation rules: (1) initially, of course, the company loses the U.S. tax savings from the disallowed U.S. R&D tax deduction; (2) if the foreign country disallows the R&D deduction -- becuase the work was not done in the country -- there is no reduction of foreign taxes to offset the U.S. increase; (3) alternatively, if the foreign country allows the deduction, in the case where the foreign is less than the U.S. tax rate, the firm would lose after-tax profits in two ways; the initial tax savings would be lower because of the lower foreign tax rate and, moreover, the firm's level of allowable tax credits would be lower for the year because overall foreign profits, the base for the allowable tax-credit calculation, is lower.

hand, technology and so-called headquarter services (administration, accounting, etc.) would be taxed only by the country in which these public-like goods and services originate. If agreed to by the major countries, all problems of double taxation would be eliminated, and the marginal tax rate on the use of technology in any location would be the same -- the tax rate of the home country.

Transfer pricing problems would still exist, as firms would have incentives to shift profits away from high-tax countries. After a detailed study of the issues, Hufbauer comes down for a great expansion of what are called "advanced price agreements" (APAs) and proposes procedures to expedite their creation.

What would such a dramatic shift in the U.S. tax system achieve? On the tax side, the net change of a score of changes would be a small increase of U.S. tax revenues of approximately $12 billion (Table 7.7, pp. 164-166). Since the point of the proposal is not revenue "enhancement," but the promotion of competitiveness and technical change, the primary quantitative appeal must be its impact on the location and growth of high-tech production and headquarters (including R&D) expenditures. HERE I AM WAITING FOR SOME CLARIFICATION FROM HUFBAUER.

Because it would mean a comprehensive overhaul of the present tax system, I doubt that Hufbauer's plan will become a serious legislative proposal in the near future. Moreover, as he would willingly admit, his estimates of the impact of his proposals on taxes and, especially, U.S. competitiveness are subject to significant errors. Nevertheless, one can profit from, and must admire, his expert dissection of the existing, Rube Goldbergesque international tax system.

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