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The U.S.System for Taxing International Business and Recent Proposals for Reform

The five Clinton Administration tax proposals that deal specifically with multinational corporations (MNCs) are merely the latest of many recent attempts to either patch or fundamentally reform the international aspects of the U.S. tax system.[1] This note analyzes a number of proposals for partial or complete reform -- including the recent Administration ones -- in the context of the present tax system and its shortcomings.

Each of the Administration tax proposals is an attempt to plug a perceived revenue leak in the current system, rather than an effort at fundamental reform. In this respect, the package is much more limited than two alternative proposals discussed below: the Rostenkowski-Gradison bill now before Congress (H.R. 5720), and the recent plan proposed by Gary Hufbauer in *Blueprint for Reform.*

Of the Administration proposals, three are new additions to the already crazy quilt set of limitations to the practice of *deferral* -- a practice that, it is argued below, has no rationale in the present U.S. tax system.[2] The other two are modest efforts to reduce transfer pricing abuses. Only one of the changes, the change in the treatment of royalties, is likely to have an economic impact beyond its revenue

1. For details and revenue estimates, see the note "Outline of Administration Tax Proposals Directed Toward International Business," (February 19, 1993).
2. The three are the reform of foreign tax credits for Oil MNCs, the change in the treatment of royalties, and the repeal of deferral for earnings from passive assets. (For details see the note listed in footnote 1.)

implications. Similar changes have been part of a package recommended by Hufbauer (1992) in order to discourage the location of R&D activities abroad (section IV below). Unlike the Hufbauer package, however, the Administration proposals will probably raise net taxes on the fruits of R&D activities, thus tending to lessen incentives for developing technologically advanced goods and services.

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.[3] 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

3. Graham and Krugman (1989), chapter 6, review 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.

providing a tax credit for foreign taxes.[4]

In the real world, however, although the principle of non-discrimination has been achieved reasonably well in practice, 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; in particular, in order to prevent high tax rates abroad from siphoning off U.S. tax revenue, the foreign tax credits necessary to achieve CEN are limited for a given firm 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. As discussed below in section IV, the Administration proposal to tax royalties as current income may go part way toward eliminating these distortions.

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

4. 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). More details can be found in Caves (1982), chapter 8, or Hufbauer (1992), chapter 3.

the policy has no rationale in such a system.[5] Instead of abolishing deferral -- which is frequently proposed (e.g., in section II, below), but ultimately proves to be politically unpalatable -- the Treasury, since 1962, has followed the strategy of narrowing progressively the types of firm income eligible for deferral. The present Administration proposals follow this strategy.

Once a deviation from capital export 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 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. Two of the administration proposals address this sensitive issue.

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. The proposed reinstitution of the investment tax credit is a case in point; it has always been limited to domestically located subsidiaries.

5. 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 can be found in Bergsten, Horst and Moran (1978), pp. 165 ff. Hufbauer (1992) provides a useful update.

Given the many existing distortions to CEN and the associated problems of tax avoidance, it is no surprise that both political and scholarly attention has focused on the reform of the system. Section II discusses the key provisions of the most prominent political effort, the Rostenkowski-Gradison bill; section III reviews the alternative revenue estimates in the most contentious area addressed by alternative proposals (including the new Administration package), the tax loss due to transfer pricing abuses. Section IV examines Hufbauer's plan, a comprehensive approach which faces the problems of tax avoidance and distortions to CEN with much more realism than H.R. 5270; it 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. Moreover, although one goal of the bill is 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 provisions 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).[6]

Abolishment of Deferral and A Provision to Override Certain Treaties

As attempted many times in the past, the second key change sought 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 subsidiaries operating in the United States. In somewhat mystical language (at present), a foreign-owned 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

6. This is the Treasury's position, as was made clear by Assistant Secretary Goldberg (1992) in his submission to the Committee on Ways and Means. The most obvious evidence of discrimination is that U.S.-owned 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 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.

country derived by residents of the foreign country."[7] 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."[8]

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 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.[9] This estimate is reported to have influenced the original Clinton campaign proposal, now superceded, to increase tax collections from foreign-owned subsidiaries by slightly over $11 billion a year. As noted above, present Administration proposals have much more modest revenue goals. This is fortunate, for there is no empirical support for the larger 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,

7. Unbelievable as it may seem, this language from Barbara Kirchheimer (1992), p. 1304, is clearer than the language in the Staff report.
8. Kirchheimer (1992), p.1304.
9. Eileen Mauskopf (1992) provides 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.

Goodspeed, and Swenson (1991), using 1987 IRS returns.[10] 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: 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.

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. His analysis also illuminates the economic rationale behind a number of the Administration's recent proposals. 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

10. 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.

goods.[11] 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 are 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. The administration proposal to transfer royalties from "active" to "passive" income will achieve Hufbauer's desired result of eliminating this free ride; however, as Hufbauer is careful to show, without some offsetting tax credits, increased taxes on foreign royalty income will discourage R&D spending.

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

11. 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.

taxes unchanged (because R&D done in the United States is usually not deductible on foreign tax returns).[12] Hufbauer anticipates another of the Administration's proposals by advocating the abolition of the allocation rules.

Hufbauer's solution, unlike the Administration's more limited package, 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 4, 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 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

12. 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 -- because 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.

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 "advance price agreements" (APAs) and proposes procedures to expedite their creation. In particular, he does not believe that more vigorous policing and documentation of transfer-pricing practices, as proposed by the Administration, will be successful in raising substantially higher tax revenues.

What would such a dramatic shift in the U.S. tax system achieve? On the tax side, according to Hufbauer, the net effect 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-technology production and headquarters expenditures (including R&D). The major effect would be on the location of production; Hufbauer calculates that the increased taxation of foreign-source income (particularly the full taxation of foreign royalties that have essentially escaped taxation) would lower after-tax returns by about 10 percent on foreign profits and shift approximately 12 percent of high-technology sales by U.S.-owned subsidiaries abroad back to the United States; in 1995 this would amount to approximately $34 billion. Since his tax and credit package for R&D is designed not to affect the overall level of R&D, but only to eliminate incentives for it to go abroad, the net effect on U.S. R&D expenditures would be small; of the estimated $8 billion in R&D estimated to be done abroad in 1995 under the existing tax law, Hufbauer calculates that about $0.7 to $2.2 billion would be shifted back to the United States.[13] Hufbauer is the first to admit that these estimates are subject to wide margins of error.

Because it would mean a comprehensive overhaul of the present tax system, Hufbauer's plan is unlikely to become a serious legislative proposal in the near future. Nevertheless, one can profit from examining what a comprehensive reform would entail. Such an examination illuminates the rationale and limited scope of the Administration's package, and provides alternatives to the unacceptable provisions of the Rostenkowski-Gradison bill.

13. For his calculations, see Hufbauer (1992), pp. 145-146.

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