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Foreign Investment and Tax Incentives: Analysis of Current Law and Legislative Proposals

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Summary

During 2004, a major focus of the tax policy debate in Congress was tax policy towards international income and investment. Major international tax legislation was approved by the full Senate in May as S. 1637 and by the House in June as H.R. 4520. (In July, the Senate approved a version of H.R. 4520, amended to include the language of S. 1637, as passed in May.) In October, both the Senate and House passed a conference agreement on H.R. 4520. The President signed the measure and it became Public Law 108-357.

The starting point for the legislation was a long-running dispute between the European Union (EU) and the United States over the U.S. extraterritorial income (ETI) tax benefit for exports. Each of the bills address the dispute by proposing repeal of ETI. But repeal of ETI raises additional tax policy questions. For example, if ETI is repealed, should alternative tax incentives be implemented for investment in the domestic economy in order to offset repeal's employment effects? And, should legislation repealing ETI be offset by tax relief for U.S. multinational firms, with an aim towards maintaining the competitive position of the United States in world markets? Sluggish domestic employment performance and concern over a perceived increase in U.S. firms' substitution of foreign for domestic employment ("outsourcing") have helped broaden the debate, with some charging that the U.S. tax system poses an incentive to invest abroad, and others defending the positive impact of profitable overseas operations on U.S. employment. Along with repealing ETI, both the House and Senate versions of the ETI bill addressed these broader questions with additional tax proposals that would affect international investment flows. Both the House and Senate bills proposed a mix of new tax benefits both for domestic and overseas investment. Another prominent ETI bill considered in 2004 was H.R. 1769, which proposed replacing ETI with a tax benefit for domestic production.

This analysis looks at two questions that the policy debate addressed. First, what is the impact of the U.S. tax system on the flow of investment abroad? Second, what would be the impact of the principal legislative proposals on that flow? It concludes that under current law, the tax system poses a patchwork of incentives and disincentives for overseas investment, in some cases encouraging U.S. firms to shift operations abroad, in some cases discouraging overseas investment. The overall, net impact of the system on incentives defines generalization. The legislative proposals considered in 2004 likewise contained a mixture of tax incentives for domestic and foreign investment and whether they would, on balance, encourage overseas or domestic investment is not clear.

This report will not be updated.

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Foreign Investment and Tax Incentives: Analysis of Current Law and Legislative Proposals

A principal focus of the congressional tax policy debate in 2004 was the impact of the U.S. tax system on firms' international investment decisions. At issue was how taxes affect a firm's decision to either expand operations in the United States or instead channel their investment resources to operations in foreign countries. The debate began narrowly with a focus on exports. The U.S. tax code's extraterritorial income (ETI) exclusion provides U.S. firms with a tax benefit in the form of a tax exemption for between 15% and 30% of their export profits, depending on the nature of their production process. In response to a complaint by the European Union (EU), a series of World Trade Organization (WTO) rulings held that the ETI benefit violates the WTO agreements' prohibition of export subsidies. In response to the rulings, Congress began consideration of legislation to repeal ETI.

But repeal of ETI raised additional tax policy questions. For example, if ETI were to be repealed, should alternative tax incentives be implemented for investment in the domestic economy in order to offset repeal's employment effects? And, should legislation repealing ETI be offset by tax relief for U.S. multinational firms, with an aim towards maintaining the competitive position of the United States in world markets? Sluggish domestic employment performance and concern over a perceived increase in U.S. firms' substitution of foreign for domestic employment ("outsourcing") have helped broaden the debate, with some charging that the U.S. tax system poses an incentive to invest abroad, and others defending the positive impact of profitable overseas operations on U.S. employment.

In keeping with the policy debate, the congressional bills that addressed ETI had a scope that was considerably broader than repealing the export subsidy. The most straightforward of the bills was H.R. 1769, which proposed to supplement ETI's repeal with just one additional provision: a tax deduction for domestic production. In May 2004, the Senate approved S. 1637, which combined ETI's repeal with a mix of tax changes, some of which would benefit domestic investment and some of which favored foreign investment. H.R. 4520, approved by the House in June, likewise contained both provisions favoring domestic investment and proposals benefitting foreign investment. (The particulars of the bill approved by the full House differ in several respects from those of H.R. 2896, an ETI bill approved by the Ways and Means Committee in late 2003. Its general thrust, however, is the same.) In July, the Senate passed its own version of H.R. 4520, amended to include the language of S. 1637, as approved in May. And in October, both the House and Senate approved a conference agreement on H.R. 4520; it became P.L. 108-357.

The focus of this report is tax incentives; it addresses two questions raised by the policy debate and the pending legislation: what is the impact of the current U.S. tax system on the flow of investment abroad? And: what would be the impact of the principal legislative proposals on that flow? The discussion that follows begins by outlining the principal tax code provisions applying to international investment, including jurisdictional principles, the deferral benefit, Subpart F, and the foreign tax credit. The report continues by assessing the current tax system's impact on the incentive to invest at home or abroad; it then evaluates the incentive effects of the most prominent legislative proposals in the current Congress. The final sections of the report rely on economic theory to identify the likely economic effects that result from the system's incentive effects.

The conclusions of the analysis are these: first, current U.S. tax law presents a patchwork of incentives, disincentives, and neutrality towards foreign investment that varies across firms and foreign locations. The net, aggregate impact of the system is uncertain. Each of the ETI bills likewise contained a mix of provisions, some favoring domestic investment and others favoring foreign operations. The likely net impact of the bills and of the measure that was ultimately enacted is also not clear.

Before presenting this analysis in more detail, we take a brief look at the basic statutory provisions of the U.S. tax system as it applies to international investment.

The U.S. System's Basic Provisions

At the heart of the U.S. system for taxing international income is a dichotomy: depending on its circumstances, a firm may face either current U.S. taxation of its foreign operations or an indefinite tax deferral. The system begins with a jurisdictional principle: the United States taxes international income on the basis of residence rather than source or territoriality. Individuals who are U.S. citizens or residents are generally subject to U.S. tax on both their foreign and domestic income. In the case of businesses, corporations chartered in the United States (U.S. "resident" corporations) are likewise subject to U.S. tax on their worldwide income. In contrast, corporations chartered in foreign countries are not subject to U.S. tax on their foreign-source income.¹

The statutory dichotomy follows from this jurisdictional principle. If a U.S.-chartered corporation conducts its foreign operations through a branch that is not separately incorporated, U.S. taxes generally apply to the firm's foreign income on a current basis — U.S. taxes apply to income in the year it is earned. In contrast, if the firm operates through a subsidiary corporation chartered in a foreign country, U.S. taxes are deferred as long as the income remains in the hands of the subsidiary and is reinvested rather than repatriated — a feature of the system known as the deferral principle, or simply "deferral." U.S. taxes apply only when the foreign income is remitted to the U.S. parent as dividends or other income, thus re-entering the U.S. tax jurisdiction.

¹ They generally are, however, subject to U.S. tax on their U.S.-source income.

There are exceptions to deferral. Since 1962, the U.S. tax code's Subpart F provisions have denied deferral to income from certain types of investment — primarily income from passive investment made through foreign corporations controlled by U.S. stockholders or parent firms (so-called controlled foreign corporations, or CFCs), along with certain other types of CFC income whose geographic source is thought to be easily manipulated.² Under Subpart F, U.S. stockholders of CFCs are subject to current U.S. taxation on their CFCs' Subpart F income whether it is actually repatriated or not. Still, the dichotomy remains, with the current taxation of Subpart F and branch income contrasting with the indefinite tax deferral of subsidiaries' active business income.

Another important feature of the system is the foreign tax credit, whose function is to alleviate double taxation. Where current U.S. taxes apply to foreign income — for example, with Subpart F or branch income — double taxation becomes a potential problem. Host countries frequently apply their own taxes to inbound foreign investment, and without some special provision, overlapping tax jurisdictions would produce combined tax burdens sufficient to stifle at least some portion of investment flows. Like most countries, the United States assumes the responsibility of relieving double taxation for its resident investors; like many countries, it does so with a foreign tax credit. Under the credit's provisions, U.S. investors are permitted to credit foreign taxes they pay against the U.S. taxes they would otherwise owe on foreign source income.

The foreign tax credit contains a number of complicating features. First, the credit is limited to U.S. tax on foreign source income; foreign taxes are not permitted to offset the portion of a taxpayer's U.S. tax that applies to domestic income. The limitation, in effect, places a barrier between a firm's foreign and U.S. income. If a firm pays foreign taxes at a high rate, it may have enough foreign tax credits to completely offset any U.S. tax it owes on foreign income. Foreign taxes that exceed that amount, however, are not creditable in the current year, and become "excess credits," in tax parlance.³

While the foreign tax credit's limitation restricts a firm's ability to credit foreign taxes, a phenomenon known as "cross crediting" can ease the limitation's effect in some cases. Cross-crediting is a phenomenon where a firm credits excess credits generated by one investment against U.S. taxes due on income from another investment. For example, a firm may have one investment in a country with low tax rates. Taken alone, the firm would not have sufficient foreign tax credits to offset all U.S. taxes due on the lightly taxed investment. If, however, the firm also has a heavily taxed foreign investment, the firm may in some situations be able to cross credit the foreign taxes from the high-tax investment against U.S. taxes on the lightly taxed investment.

² Passive investment is generally income from investments where the investor does not conduct and manage the production or business activity generating the income. Passive investment income is income such as interest, dividends, rents, and royalties.

³ Foreign taxes that exceed the limit, however, can be "carried back" and used to offset U.S. tax paid up to two years in the past and "carried forward" up to five years in the future.

While each taxpayer calculates a single, overall limitation for the bulk of its active business income, the tax code specifies several types of income for which separate limitations must be calculated. The purpose of the separate limitations (“baskets”) is to limit cross-crediting. In a manner similar to subpart F, the types of income subject to separate baskets are generally income whose source is thought to be easily manipulated — for example, income from passive investment.

A second complication is the “indirect” foreign tax credit, under whose terms U.S. parent firms are permitted to credit foreign taxes paid by their subsidiary corporations when the parent receives dividends from their overseas operations. The credits are permitted for foreign taxes the subsidiaries have paid on the profits generating the repatriated dividends. The indirect credit thus permits firms that use deferral to also utilize the foreign tax credit, although the tax savings produced by the indirect credit are also delivered on a deferred basis. The logic of the indirect credit is that foreign taxes have reduced the pool of subsidiary income available for dividend payments and so would contribute to double taxation if not credited.

Incentive Effects of the System

The basic structural features of the U.S. tax system are thus its dichotomy between current taxation and deferral, and the ability of taxpayers to credit foreign taxes, subject to limitation. We now look at the incentive effects of the system — at the manner in which U.S. taxes affect firm’s decisions to invest at home or abroad. As we shall see, the system’s effects vary widely; it can pose an incentive or a disincentive towards overseas investment, or it can be completely neutral. The system defies generalization regarding its overall, net impact on the decision to invest abroad; whether U.S. taxes, on balance, encourage or discourage overseas investment is not certain.

Economic analysis of the system’s incentives begins with the recognition that firms’ principal goal is to maximize profits — after taxes. Taxes can therefore pose an incentive for firms to invest overseas if the tax burden abroad is lighter than the burden on identical investment in the United States. Alternatively, taxes can pose a disincentive towards foreign investment compared to investment in the domestic economy. Or, taxes can be “neutral” towards the investment decision; if the tax burden is the same on foreign investment as on identical domestic projects, then taxes have no impact on where firms employ their capital.

The incentives facing U.S. investment abroad echo the two-part statutory structure of the U.S. system outlined above, with one pattern of incentives, disincentives, and neutrality applying where current U.S. taxation applies, and a second structure facing U.S. firms that use deferral. We look at each in turn beginning with current taxation — not because it is the most prevalent pattern — but for expository convenience.

Incentives Where Current Taxation Applies. As described above, current U.S. taxation can apply where investment occurs through an overseas branch or where Subpart F applies. Here, the incentives facing new investment depend

heavily on the foreign tax credit and on the tax rate imposed by the country in which investment occurs. As we shall see, investment in low-tax countries can face either tax neutrality or a tax incentive, depending on a firm's foreign tax credit situation. Investment in high tax countries faces either a disincentive or tax neutrality, again depending on the firm's foreign tax credit situation.

The most straightforward situation is the case where a firm has no existing overseas investment and thus has no existing excess foreign tax credits — for example, the case of a firm's first venture abroad, where the firm has no existing streams of income or taxes to complicate matters. Consider, first, a prospective investment in a country with low tax rates. In this case, foreign tax will offset some, but not all, of the firm's U.S. tax, and some residual U.S. liability will apply to the new investment's income. Suppose, for example, the foreign tax rate is 10%, while the U.S. firm pays pre-credit U.S. taxes at the 35% U.S. corporate tax rate. Foreign tax credits will offset 10 percentage points and the firm will pay 10 percentage points of foreign tax and 25 percentage points of U.S. tax. The combined tax rate on investment in the low-tax country is thus 35%, and while it consists of both foreign and U.S. taxes, it is equal to the tax rate on domestic investment. Thus, where current taxation applies — and a firm has no existing investment — investment in low-tax countries faces tax neutrality, and neither an incentive nor a disincentive to invest abroad.

We look next at a prospective investment by the same firm in a country with high tax rates, again keeping in mind that the firm has no existing overseas investment. Here, the investment would generate more than enough foreign tax credits to offset all U.S. tax due on the new investment. Suppose, for example, the foreign tax rate were 50%. The firm could use 35 percentage points of foreign tax to offset the entire U.S. tax liability applicable to the new investment. Because of the foreign tax credits limitation — as described above, the prohibition against crediting foreign taxes against U.S. tax on U.S. income — foreign taxes could not be credited in excess of the 35 percentage points, and the remaining 15 percentage points of foreign tax would become non-creditable "excess credits." Total taxes on the prospective investment would consist only of foreign taxes and would be paid at the 50% rate. The firm would thus face a disincentive to undertake the investment in the high-tax country.

But this was a firm with no existing foreign investment. If a corporation has existing operations abroad, cross crediting can complicate matters. As described above, cross crediting is where excess credits generated by one investment offset U.S. tax on another. To see how the phenomenon affects incentives, suppose, first, that a firm has existing foreign operations in high-tax countries so that it has a stock of available excess credits. Consider, now, a prospective investment in a low-tax country. As seen above, if this were the firm's only investment, a residual U.S. tax liability would apply and the investment would face tax neutrality. If, however, the firm has excess credits from existing investments, it may be able to use the excess credits to offset the residual U.S. tax. Thus, the only tax that would be due on the new investment, after credits, would be the low foreign tax, and the firm would face a tax incentive to undertake the investment. Cross crediting of the existing excess credits converts tax neutrality into an incentive.

Cross crediting can also affect incentives in high-tax countries where a firm has existing investment in low-tax countries. Here, the firm does not have sufficient foreign tax credits to offset all U.S. tax on its existing investment and pays a residual U.S. tax. (Firms in such situations are said to have a “deficit” of foreign tax credits rather than excess credits.) However, the firm can cross credit taxes it would pay on the prospective high-tax investment against its residual U.S. tax on existing, lightly taxed investment. The true cost of the new foreign taxes is reduced by each dollar of excess credits that can be used to offset existing U.S. taxes. At the limit, if the firm’s existing foreign tax credit deficit is large enough to absorb all the new excess credits, the effective tax burden on new investment in the high-tax country can be reduced to a rate equal to the U.S. tax rate and the high-tax investment is converted from a position of tax disincentive to tax neutrality.

Chart 1, below, summarizes the incentive pattern for foreign investments; the top three rows present the outcomes we have just described for currently-taxed investment. The first row shows the incentives facing a firm without existing foreign investment, income, or taxes; it faces a disincentive in high-tax countries and neutrality in low tax countries. The second row shows the situation for a firm with existing, heavily-taxed foreign investment that has generated excess credit; the firm faces a disincentive in high tax countries and an incentive in low-tax countries. The third row shows a firm with lightly taxed, existing foreign investment on which it pays residual U.S. taxes; it faces neutrality (or a reduced disincentive) in high tax countries and neutrality in low-tax countries.

Incentives under Deferral. While a firm can postpone U.S. tax on its foreign subsidiary’s income by reinvesting it abroad, U.S. tax may ultimately be paid when the foreign income is repatriated as dividends or other income. In this case, however, the economic principle of discounting is crucial. Discounting is the idea that a given amount of taxes (or funds in general) matters less to a firm the further in the future it is paid — as long as a dollar in tax payments can be postponed by a firm, the firm can invest the dollar and earn a return. Thus, under the deferral principle, U.S. taxes on subsidiary income recede in importance to a firm. In the case of funds reinvested abroad for long periods, deferral becomes almost indistinguishable from an outright tax exemption. For U.S. firms using deferral, foreign taxes are therefore the chief element of the total tax burden on foreign investment. Given the dominant role of foreign taxes, it follows that where foreign taxes are low compared to U.S. taxes on domestic investment, firms have a tax incentive to invest in the foreign country.

Deferral is powerless to deliver a tax benefit for investment in high-tax countries since foreign tax credits would offset all U.S. tax in any event. Firms that invest through subsidiaries thus face a tax disincentive for high-tax investment. First, consider the case of a firm without existing investments. Here, prospective high-tax investment would generate more than enough foreign tax credits to offset any U.S. tax; there would be no U.S. tax left to defer. The only tax burden would be the relatively heavy foreign tax and the investment would face a tax disincentive. Cross crediting does not change the situation.

The last row of Chart 1 recaps the incentive pattern under deferral: a disincentive in high-tax countries and an incentive in low-tax countries.

Table 1. Tax Incentive Patterns for Overseas Investment Under Current Law

	Investment in High-Tax Countries	Investment in Low-Tax Countries
U.S. Taxes Apply on a Current Basis		
No Existing Foreign Investment; No Existing Excess Foreign Tax Credits	Tax Disincentive	Tax Neutrality
Existing Foreign Investment with Excess Foreign Tax Credits	Tax Disincentive	Tax Incentive
Existing Foreign Investment with Residual U.S. Tax Liability (Foreign Tax Credit Deficit)	Reduced Disincentive or Tax Neutrality	Tax Neutrality
U.S. Taxes Apply on a Deferred Basis		
Deferred U.S. Taxes	Tax Disincentive	Tax Incentive

Incentive Impact of Other U.S. Tax Provisions. In addition to provisions that apply directly to international investment — deferral, Subpart F, and the foreign tax credit — other U.S. tax provisions affect international investment flows indirectly because they apply differently to domestic and foreign investment. In the current policy setting, a prime example is the ETI benefit. By definition, an export is produced in the domestic economy; an export tax benefit thus reduces the tax burden on domestic investment compared to foreign investment. Other examples are accelerated depreciation, the expensing allowance for equipment investment, and the research and experimentation tax credit.

Each of these provisions reduces the tax burden on domestic investment compared to that of overseas investment, and thus helps determine which foreign locations are “high-tax” countries, in relative terms, and which are “low-tax” locations. The provisions thus help determine the range of foreign locations where taxes pose incentives, disincentives, and neutrality, respectively. Chart 1 is useful to see the impact of the provisions more precisely. Suppose, for example, the area within each of the high-tax/low-tax cells were proportional to the share of overseas investment occurring in that circumstance. In terms of the chart 1, then, provisions such as ETI and accelerated depreciation help determine the location of the center line in the chart — and thus the proportion of countries posing tax disincentives, on the one hand, and incentives or tax neutrality, on the other. Since the provisions each reduce the domestic tax burden compared to the foreign tax burden, they each, in effect, shift the center line in the chart to the right, increasing the range of countries

presenting a tax disincentive or neutrality and reducing the range posing a tax incentive or neutrality. (Equivalently, the provisions increase the range of overseas investment compared to which domestic investment poses a tax incentive.) As we see in the next section, most of the individual elements in the pending legislative proposals can be evaluated in a similar way.

Incentive Impact of Legislative Proposals

As described at the outset of the report, the principal tax bills in 2004 that addressed the ETI controversy — H.R. 1769, S. 1637 (the Senate bill), the House-passed version of H.R. 4520, and P.L. 108-357 — would each repeal the export benefit, but also contained additional provisions. H.R. 1769 was the most straightforward; it would have combined ETI's repeal with just one additional provision — a 10% tax deduction restricted to domestic production. The initial House- and Senate-passed bills — H.R. 4520 and S. 1637 — also proposed to implement their own set of tax benefits for domestic investment, but also contained tax benefits for overseas investment. The measure that was ultimately enacted in October contained a blend of the House- and Senate-passed provisions. Several of the proposals that were enacted or considered would change the incentive situation confronting overseas investment in ways that are perhaps surprising. Given the complexity of the subject and the amount of attention the policy debate has given to incentives, it is thus useful to look at the incentive impact of the bills' most important elements carefully, and in detail.

Repeal of ETI (H.R. 1769, the Senate bill, the House bill, and P.L. 108-357). The ETI benefit provides U.S. firms with a tax exemption of between 15% and 30% of their export profits, depending on the particular nature of their production process. By definition, exports are produced in the country that exports; an export tax benefit such as ETI therefore provides an incentive for firms to invest in the United States rather than abroad; repeal of ETI would remove that incentive.

As in the preceding section, we can use chart 1 to get a more detailed idea of ETI's effect. Because it reduces the tax burden on domestic investment relative to foreign investment, the provision shifts the divide between high-tax and low-tax countries to the right. ETI's repeal thus shifts the divide to the left, increases the range of low-tax locations and reduces the number of high-tax countries. Repeal of ETI will thus increase the range of foreign locations for which taxes pose an incentive (or neutrality) and reduces those for which taxes pose a disincentive (or neutrality). In isolation, repeal of ETI will likely increase the share of U.S. firm's investment that occurs abroad rather than in the United States. Indeed, this particular aspect of ETI's repeal is generally accepted, and is one rationale for the presence in each bill of provisions intended to provide incentives for domestic over foreign investment.

Deduction or Tax Rate Reduction for Domestic Production (the Senate bill, the House bill, H.R. 1769, and P.L. 108-357). Each of the three bills provided a substantial new tax cut for income from domestic (but not foreign) investment. The details of the benefit differed from bill to bill, but in broad terms —

in terms of the size and nature of the benefit delivered — the bills are quite similar. As passed by the House, H.R. 4520 would have phased in a reduction of current law's top corporate tax rate of 35%, initially to 34%, and then to 32% for 2006 and thereafter. As passed by the Senate and as ultimately included in the conference agreements, S. 1637 proposed to phase in a 9% deduction from taxable income. H.R. 1769 proposed a phased-in 10% deduction. (The deductions in H.R. 1769 and the Senate and conference committee bills are the equivalent of a reduction in the tax rate to 31.85% and 31.5%, respectively. In the case of each bill, the proposed benefit would be restricted to income from production activities occurring within the United States.

The incentive effect of each of the domestic benefits would be the reverse of ETI's repeal — because the benefits would be restricted to domestic production, they would reduce the tax burden on domestic, but not foreign source income. The benefit, in isolation, would thus pose an incentive for firms to invest in the domestic economy rather than abroad. The proposals would thus reduce the range of countries constituting low tax investment locations and increase the number of high tax countries. In terms of chart 1, the domestic benefits would shift the center line dividing high- and low-tax countries to the right, expanding the foreign locations posing a tax disincentive for overseas investment and reducing the incidence of tax incentives or tax neutrality towards foreign locations.⁴

The deductions provided by H.R. 1769 and S. 1637 as passed by the Senate contained a special rule (sometimes called a “haircut”) that strengthened the deductions' incentive effect. The provisions would be permanent under H.R. 1769 but would expire after 2012 under S. 1637. The haircut reduced the size of a firm's deduction in proportion to the share of the firm's production that occurs abroad. For example, if one-quarter of the value of a firm's production occurs overseas, its maximum deduction for domestic production income would be reduced from 10% (9% under S. 1637) to 7.5% (10% minus 1/4 times 10%). The haircut would magnify the domestic incentive (or, equivalently, magnify the foreign disincentive) because each additional foreign investment would diminish the deduction for domestic production. The haircut was not included in the conference agreement that became P.L. 108-357.

Other Tax Benefits for Domestic Investment (the Senate bill, the House bill, and P.L. 108-357). While the rate reductions and production deductions are the largest tax-cut provisions in each bill, the House and Senate bills along with the conference agreement also contained additional substantial tax cuts that applied to domestic but not foreign investment. The provisions differed between the bills. In the Senate, S. 1637 would have extended a temporary increase in the carryback period for net operating losses (NOLs) — generally, the amount by which

⁴ The magnitude of the shift would be similar, but not identical among the bills. Again, the deductions and rate reductions differ slightly in their size, though all are in the neighborhood of a 3 percentage point tax-rate reduction. In addition, H.R. 1769 would reduce a firm's deduction in proportion to the extent of its overseas activity — a firm could not claim the bill's full 10% deduction unless it has no foreign production. This feature would magnify the bill's incentive for domestic over foreign production. S. 1637's deduction contains a similar feature that would expire after 2012.

a firm's allowable deductions for tax purposes exceeds its gross income. Under current law, the carryback period is generally two years, although the carryback was temporarily extended to five years for NOLs incurred in 2001 and 2002. S. 1637 would also have extended the carryback period to five years in the case of NOLs arising in 2003. S. 1637 would also extend the research and experimentation (R&E) tax credit through 2005. (The credit is currently scheduled to expire at the end of June, 2004.) As described above, the research credit is only available for investments in research and development made in the United States and would therefore increase firms' incentive to invest in the domestic economy. In the case of NOLs, conversion of carryforwards into carrybacks (as under the bill) would likely accentuate the benefit firms receive from tax preferences such as accelerated depreciation, that accrue primarily to domestic investment. Thus, to the extent the NOL provision has an incentive effect, it would favor domestic investment. Here, however, since the provisions would only apply to NOLs arising in one year (2003), any incentive effect from the proposal would likely be limited. Neither the NOL nor R&E credit provisions were included in the conference agreement.

In addition to its reduction of the top corporate tax rate, the House-passed version of H.R. 4520 would have reduced the tax rates applicable to the lower and intermediate tax rates that apply to small and medium-sized corporate incomes. Also, the bill extended for an additional two years an increase in the cap on the "expensing" tax benefit small firms can claim for investment in equipment under section 179 of the tax code. The expensing allowance was only available for investment in the United States, and while the reductions in the lower corporate tax rates would apply (in principle) to both domestic and foreign income, the reduction would favor domestic investment simply because the U.S. corporate tax rate applies more frequently to firms' domestic income than foreign income. Each of these provisions would favor domestic over foreign investment. The conference agreement did not contain the House bill's rate-cut provision, but did extend the expensing allowance for two years.

In terms of Chart 1, each of these provisions favoring domestic investment would shift the center line to the right, reducing the range of low-tax countries, where taxes pose an investment incentive (or neutrality).

Foreign Tax Credit's Interest Allocation Rules (the Senate bill, the House bill, and P.L. 108-357). The single largest tax cut the bills proposed in the international area — a proposal that was included in the conference agreement — was a revision of current law's rules for allocating interest expense for purposes of the foreign tax credit's limitation. Since the revision applies to the foreign tax credit, its benefit accrues to multinational firms. Yet the proposal is a prime example of how incentive effects can be surprising — the change is likely to favor domestic rather than foreign investment. In view of this surprising result and the provision's relatively large revenue impact, it is useful to look at the analysis more closely.

The revision works as follows: as described above, the tax code limits the foreign tax credit to the portion of a firm's U.S. pre-credit tax liability that applies to foreign rather than domestic income. To calculate the limitation, then, taxpayers must separate their taxable income into that having a foreign source and that with a domestic source. Because taxable income consists of gross income (generally,

revenue) minus deductible costs, the “sourcing” of taxable income requires, in turn, that a taxpayer assign both items of income and deductible costs to either domestic or foreign sources.

For firms that have excess foreign tax credits and for whom the foreign tax credit limitation is a binding constraint, whether a particular item of cost is assigned to a U.S. or foreign source can have an important impact on their after-credit tax liability. To illustrate, if a deduction is assigned to a foreign rather than domestic source, it is subtracted from foreign rather than U.S. gross income and reduces foreign taxable income rather than U.S. taxable income. Because foreign taxes are only permitted to offset U.S. tax on foreign taxable income, allocation of the deduction to foreign sources reduces the maximum amount of foreign taxes that a firm can credit. Perhaps a more straightforward way of viewing this effect is by recognizing that firms with excess credits have no after-credit U.S. tax liability on foreign source income. Thus, any deductions expenses allocated to foreign sources are powerless to reduce taxes further and are, in effect, lost.

The tax code and associated Internal Revenue Service regulations contain elaborate rules governing the allocation of income and costs — including rules governing the allocation of interest expense. Current law provides for the allocation of interest expense based on the proportion of the firm’s assets that are located abroad. Thus, even if all of a domestic firm’s borrowing is done in the United States, part of its interest expense may be allocated abroad. This is based on the notion that debt is fungible — that regardless of where borrowing occurs, it funds the totality of a firm’s investment.

U.S. firms have long complained about the operation of current law’s interest allocation rules — a method of allocation known as “water’s edge.” Under this method, a firm’s foreign assets consist only of those it owns directly (for example, the assets of a foreign branch) and the stock it owns in any foreign subsidiaries. The foreign subsidiaries’ debt-financed assets, in other words, are not included in the calculation. In isolation, this omission has the effect of reducing the amount of interest allocated to foreign sources and increases creditable foreign taxes. But a second feature of current allocation rules works in the opposite way: none of a foreign subsidiary’s interest expense is included in the calculation or allocated to domestic sources — such an inclusion could reduce domestic income and increase creditable foreign taxes. Mathematically, the impact of omitting foreign interest is larger than that of omitting foreign assets so that, on balance, omitting foreign debt from the formula reduces creditable foreign taxes.

Both H.R. 4520 and S. 1637 proposed to substitute a “worldwide” allocation regime for current law’s water’s edge rule — a change that was adopted in P.L. 108-357. Under this method, the interest costs of foreign subsidiaries would be explicitly included in the allocation formula and subsidiary assets would be included in the allocation formula on a gross basis rather than a net-of-debt basis — that is, all of a subsidiary’s assets would be included in the allocation calculation, not just the parent’s equity stake. In isolation, the first of these changes would increase firms’ foreign tax credits and reduce U.S. taxes while the second would have the reverse effect. On balance, however, the first effect would dominate and switching to the

proposals' worldwide allocation regime would increase firms' foreign tax credits and reduce their after-credit U.S. taxes.

The revision will at the same time probably reduce the attractiveness of foreign investment. Again, the amount of interest allocated to foreign sources is proportional to the share of a firm's assets that are located abroad. This effect would be magnified under the proposal, since all a subsidiary's assets would be included in the calculation. Each additional foreign investment would thus increase foreign allocations of interest, reducing a firm's foreign tax credits and increasing its after-credit tax liability. In effect, this would increase the tax burden on new foreign investment. In terms of the overall incentive structure, it will expand the number of high-tax countries and reduce the number of low-tax countries, increasing the range of locations posing a tax disincentive for investment and reducing the number of foreign locations posing a tax incentive.

Temporary Tax Rate Reduction for Repatriated Foreign Earnings (the Senate bill, the House bill, and P.L. 108-357). Notwithstanding the deferral principle, income earned by foreign subsidiaries of U.S. firms is ultimately subject to U.S. taxes when it is repatriated to the U.S. parent firm as dividends or other income. Foreign tax credits can offset some or all of the U.S. tax under the indirect credit rules, but a residual U.S. tax may be due after credits. Some commentators have argued that the imposition of U.S. tax on repatriations acts as an impediment to the repatriation of funds, and encourages U.S. firms to reinvest foreign earnings abroad. Accordingly, it is argued that a reduction in the tax that occurs upon repatriation will stimulate an increase in repatriations. For its part, the Senate-passed bill proposed a temporary, one-year reduction in the corporate tax rate applicable to repatriated dividends to 5.25% from the 35% rate that would ordinarily apply. As passed by the House, H.R. 4520 proposed a six-month 85% tax deduction for repatriated dividends, a deduction that would produce the equivalent of a 5.25% rate for a firm paying the top 35% rate without the deduction. The conference agreement adopted the one-year rate reduction.

What will be the likely impact of the rate reduction on investment incentives? The rate reduction could possibly temporarily stimulate repatriations by firms with existing, mature operations overseas, thus reducing overseas investment at least temporarily.⁵ But even if the rate reduction does stimulate repatriations, there is little reason to believe that it would lead firms to increase their investments in the United States. Firms' incentive to undertake new investment depends on the aftertax return to the prospective investment and the rate of return savers require of investments in the corporate sector; the rate reduction alters neither of these parameters, suggesting that any repatriated funds would more likely be paid out as dividends or used to reduce debt. Further, if the rate reduction is viewed as a provision that will be

⁵ However, a prominent theoretical analysis in the economics literature also suggests that if the tax cut is seen as permanent, it will not make a difference in firms' repatriation behavior. According to this line of reasoning, repatriation taxes have no impact on firms' incentive to repatriate because the repatriation taxes must ultimately be paid, regardless of whether the repatriation occurs in the present or in the future. For a more detailed discussion, see CRS Report RL32125, *Tax Exemption for Repatriated Foreign Earnings: Proposals and Analysis*, by David L. Brumbaugh.

renewed when its expiration date approaches, it may actually increase overseas investment compared to domestic investment: a permanent reduction of the tax due upon repatriation would increase the aftertax return on overseas investment compared to domestic investment, albeit on a deferred basis. If the proposal is accepted as temporary, however, it is not likely to alter investment incentives.

Consolidation of Separate Foreign Tax Credit Limitations (“Baskets”) (House bill, P.L. 108-357). As described above, taxpayers are required to calculate separate foreign tax credit limitations for certain types of income. The purpose of the separate baskets is to limit cross crediting; the types of income subject to separate baskets includes income whose source is thought to be easily manipulated, or that are typically subject to either unusually high or unusually low tax rates. Under current law, nine separate limitations apply, including an “overall” limitation that applies to most active business income. A partial list of the remaining baskets includes income from passive investment; income subject to high foreign withholding taxes; financial services income; and shipping income.

As passed by the House, H.R. 4520 proposed to reduce the number of baskets to two: a general income category and a passive income category. This provision was included in the conference agreement. Its impact will likely be to increase opportunities to cross credit foreign tax credits — that is, to credit excess credits generated by one stream of income against U.S. taxes on another stream of income that was formerly in a different basket. The impact of the revision will also probably be to reduce the tax burden on new overseas investment where cross crediting can be used.

For a firm using deferral, expanded cross-crediting could reduce the residual U.S. tax liability that applies to dividends upon repatriation, albeit on a deferred basis. The provision will thus probably accentuate deferral’s incentive for investment in low-tax countries. Under both current law and H.R. 4520, however, active income is placed in a common basket; it is thus likely that the consolidation of baskets could apply more frequently to investment that is passive in nature, and is thus subject to current taxation under Subpart F. For investment subject to current taxation rather than deferral, we return to the analysis above (see the discussion beginning on page 4, above) of incentive patterns. If a firm has excess credits, the enhanced cross crediting would convert some instances of tax neutrality into tax incentives; for a firm has a deficit of credits, the cross crediting would convert some disincentives for high-tax investment into neutrality.⁶ In isolation, the proposal would likely expand overseas investment.

Expanded Carryover for Foreign Tax Credits (Senate bill, P.L. 108-357). Where a firm’s foreign tax credits exceed U.S. tax on foreign income, the credits can be “carried back” and used to offset pre-credit U.S. tax (if any) on foreign income from the two preceding years. If the carryback reduces the firms’ after credit tax liability from either of carryback years, it will receive a tax refund. If the

⁶ In terms of chart 1, the proposal would shrink the range of investments contained in the cells of the chart’s first row (where no cross-crediting occurs), and expands the volume of investment in the second and third rows.

carryback does not exhaust a firm's excess credits, the credits can be carried forward and used to offset pre-credit U.S. tax in the five succeeding years. S. 1637 proposed to shorten the carryback period to one year, but lengthen the carryforward period to 20 years. The conference agreement shortened the carryback period to one year, but extended the carryforward period to only 10 years.

Many multinationals will probably register no change from the provision, including firms without excess credits, but also firms that have always had excess credits in the past and that expect to always have excess credits in the future. (Among these latter firms, the change will likely make no difference, since their excess credits would expire regardless of the length of the carryforward period.) Thus, the impact of the proposal will likely be concentrated among firms that currently have substantial excess credits, but expect to move to a deficit-of-credits position in the future. In the long run, the proposal will likely be most important for firms that move into and out of excess credit positions.

Most affected firms will probably register an increase in creditable foreign tax credits under the provision, although some may register a reduction due to the plan's shortened carryback period.⁷ This increase in creditable foreign taxes will likely have an impact on incentives similar to that of the consolidation of limitation baskets. For firms using deferral, it will accentuate the existing incentive for investment in low-tax incentives. For firms subject to current taxation, it would convert some instances of neutrality into incentives and disincentives into neutrality.

The effect of the carryforward's extension may in some cases be the opposite of that of a temporary tax cut for repatriations. Suppose, for example, a firm that has earnings produced by a foreign subsidiary has excess credits that it expects to expire shortly because of the five-year carryforward limitation. The firm may be induced to accelerate the date on which it repatriates the subsidiary's earnings so as to utilize foreign tax credits before they expire. Extension of the carryforward would relax this inducement, and might lead the firm to reinvest income abroad rather than repatriate it.

Recharacterization of Domestic Losses (House bill, Senate bill, and P.L. 108-357). The U.S. tax code contains special loss carryforward rules that interact with the foreign tax credit provisions in a way that can, under current law, increase the tax liability of a firm whose domestic operations incur losses. The loss rules work as follows: if a firm's allowable deductions in a particular year exceed its gross revenue, it registers a negative amount of taxable income, or a loss for tax purposes (termed a "net operating loss," or NOL). NOLs can be carried back and deducted from positive taxable income (if any) in the preceding two years; NOLs not used as carrybacks can be carried forward up to 20 years. Deductible carrybacks generate tax refunds; carryforwards generate tax savings in the future year to which they are carried.

⁷ For example, a firm that currently anticipates carrying back excess to the second preceding year would either lose its carried-back credits (if it anticipates being in an excess credit position indefinitely) or would be able to use them only on a deferred basis, as the carrybacks are converted to carryforwards.

If a firm incurs a tax loss with respect to its domestic operations, the loss reduces foreign-source taxable income, thus reducing the firm's pre-credit U.S. tax on foreign income. However, as described above in the discussion of the interest allocation rules, where firm's have excess credits, deductions allocated to foreign source income do not generate tax savings, and are, in effect, lost. At the same time, deduction of the loss absorbs an equal amount of the firm's potential NOL carryforward, and thus reduces the tax savings the firm would ultimately realize in the future year to which the NOL would be carried. In effect — prior to enactment of P.L. 108-357 — the foreign tax credit rules deny the use of some or all of the firm's NOL carryforward.

The House, Senate, and conference bills alike permit taxpayers that incur a domestic NOL in a particular year to recharacterize a portion of U.S.-source income earned in future years as foreign-source income. The provision limits the amount of income that could be recharacterized to 50% of a firm's U.S.-source income.

While the purpose of the provision is to compensate for the treatment of domestic NOLs, the incentive impact of the plan will likely fall on overseas investment, since the bills' actual rule change applies to foreign tax credits; it increases creditable foreign taxes for firms with excess credits. As with the foreign tax credit carryovers, the provision's effect will be similar to that of cross crediting; it will permit excess credits from new, heavily-taxed foreign investment to offset U.S. tax due on other streams of income, or it will permit excess credits from existing investment to offset U.S. tax on lightly-taxed foreign investment. Where deferral applies, the proposal will thus accentuate the existing tax incentive for low-tax investment. Where current taxation applies, the proposal will convert a tax disincentive into neutrality or a tax neutrality into an incentive.

Net Impact of Proposals

The preceding section describing the incentive effects of the current U.S. tax system concluded that the overall, net effect of the system on incentives is ambiguous.⁸ The different elements of the system have different effects in different contexts so that the average impact of U.S. taxes on the decision to investment at home or abroad is uncertain. Even given the preceding analyses of the incentives in the three ETI bills, however, we can reach no more definite conclusion regarding current legislation: it is not clear whether any of the bills would, on balance, increase firms' incentive to invest abroad, pose an incentive to invest in the domestic economy, or produce no net impact in either direction.

From the preceding analysis of incentives, it is clear that each bill contains both provisions that would favor foreign investment (or disfavor domestic investment) and proposals that would favor domestic investment. The net, overall impact of each bill thus depends on the relative magnitude of the changes in either direction.

⁸ See the section entitled "Incentive Effects of the Current System," above.

A definitive assessment of the magnitude of each change and an assessment of the net impact of the bills would depend, first, on estimates of the bills' impact on what economists term the "rental cost of capital" — a concept that measures the rate of return corporate investments must earn, before taxes, in order to generate the rate of return, after taxes, that is required by savers. According to economic theory, the rental cost is the parameter to which firms respond in making investment decisions. In addition, the bills' impact would depend on the amount of investment affected by each provision's change in the rental cost. Such rental cost and capital stock estimates for a bill as large and complex as those at hand is not attempted here.

As a substitute measure of the bills' impact on investment, it is informative to examine estimates of impact of the bills on tax revenues, comparing the expected impact of those provisions that favor foreign investment with the effect of those favoring domestic investment. (As we shall see, however, such measures likewise yield no firm conclusions regarding the bills' net impact on investment.) In examining the proposals' revenue impact, for each bill we look at the average annual revenue impact of the bill's most important components, comparing the revenue effect of those favoring domestic investment with the impact of those favoring foreign investment. To compare the different provisions on an even footing, we include only those years for which the provisions are on an even footing. Also, we include estimates for temporary provisions, such as temporary extension of the research credit and extension of a five-year carryback for tax losses. Thus, the comparisons are not accurate if it is assumed that the provisions will not be extended.

The comparison of the bills' different elements is most straightforward for H.R. 1769, since it only contains two provisions: repeal of ETI and a new domestic production deduction. Detailed revenue estimates are not available for the bill, but its sponsors have stated that the revenue gain from repeal of ETI would match the revenue loss from its new tax deduction — an outcome that appears reasonable, given estimates of similar measures in the other bills. While at first glance, it might therefore appear that H.R. 1769 would have a neutral impact on incentives, the "haircut" provision associated with its deduction (the provision that reduces the bill's deduction for firms with overseas income) suggests at least the possibility that the deduction would produce a more powerful incentive effect for marginal domestic investments than ETI's repeal.⁹

The House, Senate, and conference committee bills have a more varied mix of provisions, so we look at the bills separately, beginning with S. 1637, the Senate bill. According to calculations using revenue estimates by the Joint Committee on Taxation, the average annual revenue impact of those provisions reviewed in this report that probably favor foreign investment (or, as with ETI's repeal, dis-favoring domestic investment) sums to \$7.9 billion. The annual revenue impact of provisions favoring domestic investment totals \$19.8 billion. In the case of the House bill, the average annual revenue impact of provisions favoring foreign investment is \$8.1

⁹ For a more rigorous analysis of the haircut provision, see CRS Report RL32103, *Comparison of Tax Incentives for Domestic Manufacturing in Current Legislative Proposals*, by Jane G. Gravelle.

billion; the revenue impact of provisions favoring domestic investment is \$12.8 billion. For the conference agreement, the annual revenue impact of foreign investment provisions averages an estimated \$9.0 billion; the average for domestic provisions is \$12.7 billion. Thus, in the case of the conference agreement as well as the House and Senate bills, the revenue impact of provisions favoring domestic incentives appears larger than those favoring foreign investment.¹⁰

But too much uncertainty still remains to conclude that all of the bills would favor domestic investment, and would thus increase domestic investment compared to current law. Most importantly, a large portion of the revenue impact measures the impact of the tax law changes on investment that is already in place, “infra-marginal” investment, in the language of economics. For example, the largest revenue impact in the bills would result from reductions in tax rates, or from provisions that have the same impact as rate reductions. Here, the bills’ rate reductions would reduce the tax liabilities that apply to the current and future revenue streams from investments that firms have already placed in service. While revenue estimates necessarily include this effect, any impact on infra-marginal investments is not reflective of changes in investments, since the decisions leading to those investments have already been made. Other important provisions that may have large infra-marginal effects include the temporary extension of the NOL carryback and the reduced tax rates for lower corporate incomes.

Summary and Implications

The analysis here has focused on the incentive impact of current tax laws and pending legislative proposals. While it reached no definite conclusion regarding the net impact of the proposals, it is nonetheless informative to conclude by looking briefly at economic theory’s understanding of why the international investment incentives examined here matter.

Economic theory provides a framework for evaluating taxes on international investment flows. First, when taxes affect where capital is employed, they can also affect capital’s efficiency. When taxes do not distort firms’ decisions on whether to invest at home or abroad — when taxes are neutral — firms will employ their capital in the most productive location, and thus promote economic efficiency. A tax system that is neutral in this fashion is said, in tax parlance, to promote “capital export neutrality.” Since capital is employed in the most productive way possible under this standard, world economic welfare is maximized.

¹⁰ Note also that several temporary provisions — specifically the NOL extension and increased expensing amount — would only be in effect for one year. However, since both provisions change the timing rather than amount of taxes, shifting tax revenues from the present into the future, a one-year snapshot of their revenue impact during the year of implementation would overstate their relative impact compared to other provisions that do not depend on timing. Thus, we have included the revenue impact of these one-year provisions during the entire estimating window. In a strict sense, then, their revenue estimates show the impact of a one-year implementation of the provisions.

Tax policies that promote national welfare (here, the welfare of the United States) can diverge from those that maximize world economic welfare. Specifically, if a country is a large exporter of capital (as is the United States), national economic welfare can be increased by a tax policy that discourages — to some extent — the export of capital. Such a tax policy is termed “national neutrality,” and applies higher taxes to overseas investment than to investment in the United States. Finally, those that support the competitive position of U.S. multinationals abroad support a policy under which foreign investment is not taxed, so as to place U.S. firms on the same footing as competitors from other countries. Such a policy has not been accepted in the mainstream of the economics literature.¹¹

The location of the current system in the this framework is not clear; so to is the likely impact of the proposals. As described above, the existing system presents a patchwork of incentives, disincentives, and neutrality; whether the system is more consistent with capital export neutrality, national neutrality, or an exemption system is not clear. Because of this uncertainty, even if analysis had produced a definite conclusion regarding the impact of the proposals on investment, the impact of the bill’s on efficiency would still be uncertain. For example, if it were certain that all of the bills would domestic investment, it would still be unclear whether they would move the system towards the point at which national welfare is maximized or beyond it. There is a point, in other words, beyond which providing additional tax inducements for domestic investment (or disincentives for foreign investment) reduces the pre-tax productivity of capital to such an extent that even national welfare is diminished by additional distortions favoring domestic investment.

In addition to efficiency, the location in which an economy’s capital resources are used can affect the distribution of income shares in the economy. Generally, the larger the share of capital employed within the domestic economy, the higher is the capital/labor ratio, the higher is labor productivity, and the higher are labor earnings. Thus, the larger the portion of the capital stock that is employed in the domestic economy, the larger the share of income that accrues to labor rather than capital. Here, too, the impact of the bills is not clear.

¹¹ For a thorough review of the economics literature on the optimal taxation of international investment, see Donald Rousslang, “Deferral and the Optimal Taxation of International Investment Income,” *National Tax Journal*, vol. 3, Sept. 2000, p. 589.