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Key Issues in Tax Reform: International Tax Issues

Issues surrounding the taxation of U.S. multinational corporations have been a major impetus for tax reform and are some of the main arguments for tax measures to lower the statutory corporate tax rate of 35% and revise the current system for taxing foreign source income.

Current Law

A territorial or source-based system taxes only income earned in the country and excludes foreign source income. A worldwide system taxes both income earned in the country and foreign source income, but allows a credit for income taxes paid to foreign jurisdictions. Most countries have largely territorial systems.

The U.S. system has elements of both. While it taxes worldwide income, earnings of foreign subsidiaries of U.S. multinationals are not taxed until they are repatriated (paid as dividends to the parent). Earnings of foreign branches and royalties and interest payments are taxed currently. A foreign tax credit is allowed, but limited to the total U.S. tax due. This limit is applied separately to active and passive income. This overall limit allows cross-crediting so that firms can use excess credits from high-tax countries to offset U.S. tax on earnings in low-tax countries. Deferral of tax on earnings of foreign subsidiaries and cross-crediting introduce elements of territorial taxation, and the United States collects relatively little foreign source income.

In common with many other countries, the United States taxes certain easily shifted income of foreign subsidiaries on a current basis. These rules are called CFC rules (for controlled foreign corporations) or Subpart F rules (for the tax code section). Subpart F income includes passive income of subsidiaries and certain other income such as income from sales and services subsidiaries in foreign countries where the production and consumption takes place in other countries. The effectiveness of Subpart F has been reduced by check-the-box regulations that allow payments between subsidiaries to be disregarded.

Issues

Four issues are of concern: the effect on investment abroad, revenue losses due to profit-shifting, repatriation, and inversion.

Allocation of Investment

Broadly speaking, strong territorial elements of the U.S. system provide an incentive to invest in countries with low tax rates of their own and a disincentive to invest in high-tax countries, including a disincentive to invest in the domestic economy. According to traditional economic analysis, world economic welfare is maximized by a system that applies the same tax burden to prospective (marginal) foreign and domestic investment so that taxes do not distort investment decisions. National welfare is maximized, however, by encouraging more investment in the United States. (For a discussion of these principles, as well as other international issues and details of various proposals, see CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.) Some of the arguments for lowering the U.S. statutory corporate tax rate, which is the highest of almost all countries, relate to the concern about domestic investment. The location of investment, however, is driven by effective rather than statutory tax rates; U.S. effective tax rates are more in line with those in other countries (see CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle).

Profit Shifting

Profit shifting involves the movement of profits without real activities to countries with low tax rates, such as the Cayman Islands and Bermuda. Considerable evidence points to significant profit shifting by U.S. multinationals. Profit shifting is driven by statutory tax rates.

Profit shifting primarily rests on two methods: leveraging and transfer pricing of intangibles. Firms can shift profits by borrowing in high-tax countries. Transfer pricing involves the sale of intangible assets (such as drug formulas, technological advances, and trademarks), charging a low price to subsidiaries in low-tax countries. Firms also use cost contribution arrangements where a low-tax subsidiary contributes to research in the United States for a share of the rights to the intangible.

Repatriation

Deferral of tax causes a tax to be triggered when foreign subsidiaries repatriate income. When there are no foreign tax credits to offset U.S. tax, each dollar repatriated results in a tax at the statutory rate. Estimates indicate that firms have around $2.5 trillion of accumulated profits offshore. This repatriation tax could be eliminated in a system that taxed foreign source income currently (a worldwide tax without deferral) or a territorial tax where foreign source income is not taxed.

Inversions

Inversions occur when a U.S. firm moves its headquarters abroad, currently by merging with a foreign firm. Mergers where the U.S. firm maintains 80% or more ownership are treated as U.S. firms, while 60% to 80% ownership triggers other, less costly tax effects. Inversions grew rapidly in 2014 and 2015, but have declined somewhat in 2016 according to Commerce Department data. Some of the decline in inversions may be due to a series of regulations that made it more difficult to invert and limited some of the potential benefits, such as indirect repatriations through loans to the new parent and leveraging. (See CRS Report

R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.)

Options for Reform

Fundamental options include eliminating deferral (tax foreign source income currently) at one end of the spectrum or moving to a territorial system (exempt that income) at the other. A choice could also be made for an intermediate approach where foreign source income is taxed currently, but at a lower rate. These approaches would likely be accompanied by a deemed repatriation of existing earnings, possibly at a lower rate.

Any of these approaches would eliminate the incentive to retain earnings abroad. Eliminating deferral would raise revenue and eliminate incentives for profit shifting, but would make inversions much more attractive. Thus, such an approach might need to be accompanied by tighter rules on inversions. A territorial tax would make inversions less likely but might encourage more profit shifting because profits shifted would never be taxed. For that reason, moving to a territorial tax system might require stronger anti-abuse rules, such as allocation of interest deductions based on the worldwide share of profits and a minimum tax on intangible income in low-tax jurisdictions. A system that taxes foreign source income at a lower rate might represent a compromise for dealing with profit shifting and inversions.

Narrower revisions would restrict deferral and cross-crediting, profit shifting, and inversions in the context of the current system.

The Current Tax Reform Proposals

The current tax reform proposals passed by the House (H.R. 1) and reported out of the Senate Finance Committee would move to a largely territorial tax by exempting dividends from 10% owned foreign subsidiaries. It would lower the corporate tax rate to 20% and provide a deemed repatriation of existing earnings abroad (at a rate of 14% on cash and 7% on other assets in the House and 10% and 5%, respectively, in the Senate).

Both proposals have new anti-abuse provisions. First, the House bill would tax 50% of the income of foreign subsidiaries in excess of a return on tangible assets of 7% plus the federal short-term rate. The objective is to tax intangible income by exempting a normal return to tangible assets. Since the new tax rate is 20%, the tax rate will be 10%. A foreign tax credit is allowed for 80% of foreign taxes paid. The treatment is global and not per-country (allowing cross-crediting between low- and high-tax countries), but the income and credits are in a separate basket to prevent cross-crediting with other income.

Second, the House bill provides an allocation of interest rule for affiliated firms that limits the share deducted to 110% of the share based on the share of the affiliate's earnings before interest, taxes, and depreciation. This provision is aimed at profit-shifting through leveraging.

Third, a base erosion tax of 20% is imposed on payments by U.S. firms to foreign affiliates. The excise tax does not apply if the firm elects to treat the income as effectively connected (and thus subject to the corporate tax at the same rate), and firms that so elect can get a credit for 80% of foreign taxes paid. The payments exclude interest, certain other financial payments, and the cost of services with no markup if the payor uses a services cost method under Section 482 (transfer pricing rules). This rule is aimed in part at profit shifting through transfer pricing of goods and royalties.

The Senate has four major provisions, with some corresponding in general intent to the House provisions. First, it imposes a tax on foreign source income also on a global basis, with an exclusion for a 10% return on tangible assets. A deduction will be allowed for 50% of income through 2025 and 37.5% thereafter. Thus, the tax rate will begin at 10% and rise to 12.5%. A foreign tax credit will be allowed for 80% of foreign taxes paid.

Second, a tax deduction is allowed for foreign derived intangible income of domestic firms of 37.5% through 2025 and 21.875% thereafter. Thus the rates would be 12.5% and then 15.625%. Foreign derived intangible income is total intangible income of the domestic firm multiplied by the ratio of its exports (sales of goods and services abroad) to gross income. The purpose of this provision is to encourage intangible assets to stay in or return to the United States. (There is also a provision to treat the fair-market value of intangible property transferred by a foreign subsidiary to a U.S. firm as the adjusted basis so that it makes the transfer tax free.)

Third, the bill contains an allocation-of-interest rule for affiliate firms that limits the share deducted to 110% (beginning at 130% in 2018 and phased down to 110% by 2022) of the share allowed if it were proportional to the share of debt to equity.

Fourth, a base erosion minimum tax imposes a minimum tax of 10% (12.5% after 2025) on the total of base erosion plus taxable income.

Arguments have been made that some elements of these provisions would violate World Trade Organization rules against export subsidies or violate existing tax treaties. The foreign derived intangible income deduction may be viewed as an export subsidy, while the base erosion taxes may be viewed as a tax on imports. The requirement in the House bill to consider foreign income as effectively connected U.S. income to receive the foreign tax credit for intangible income may violate treaty agreements about the rules for permanent establishments, and the base erosion taxes may also violate treaties.

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