

CRS Report for Congress

U.S. Taxation of Overseas Investment and Income: Background and Issues in 2005

January 31, 2005

David L. Brumbaugh
Specialist in Public Finance
Government and Finance Division



Prepared
for the
Com

TAB 132
AMERICAN JOBS
CREATION ACT. H.R. 4520,
PL 108-357



U.S. Taxation of Overseas Investment and Income: Background and Issues in 2005

Summary

Investment abroad by U.S. individuals and firms is substantial and growing — an important aspect of the increased integration of the U.S. economy with the rest of the world. At the end of 2001, the overall stock of private U.S. investment abroad was 18.2% of the total U.S. stock of private capital; the proportion has more than doubled over the past two decades. And because investment outflows have grown, it is not surprising that U.S. taxation of overseas investment has been and is likely to remain a prominent issue before Congress. First, because investment abroad is an increasingly important part of the economy, the effects of taxation on foreign investment are potentially more important. Second, the increased mobility of capital has changed the environment in which taxes apply; some have suggested that capital's mobility may call for a change in U.S. tax policy.

Current U.S. tax policy towards investment abroad poses a patchwork of incentives, disincentives, and neutrality, and different features of the system have different effects. The foreign tax credit generally promotes tax neutrality; the credit is limited, however, and the limitation can pose either a disincentive or incentive to invest abroad. The system's deferral principle in some cases permits U.S. firms to postpone U.S. tax on foreign income; it poses an incentive to invest abroad where foreign tax rates are low. Deferral is restricted, however, by the tax code's Subpart F, which nudges the system back in the direction of tax neutrality.

Whether these various effects are beneficial depends, in part, on the perspective a policymaker takes. Traditional economic theory suggests that a tax policy that promotes neutrality between investment at home and abroad best promotes world economic welfare. Economic theory also indicates, however, that U.S. economic welfare is maximized when overseas investment is to a degree discouraged. Yet a third perspective is supported by many investors and multinational firms, who emphasize the importance of the competitive position of U.S. firms in the world market place. Different components of the U.S. system are consistent with different perspectives; which perspective the U.S. system best exemplifies is not clear.

The varied effects of the system suggest an ambivalence towards overseas investment on the part of policymakers and the public. And in 2004, the American Jobs Creation Act (AJCA; P.L. 108-357) echoed the underlying system's complex nature by itself implementing changes that vary in their likely effect on foreign investment. This implied ambivalence — along with foreign investment's growing importance — suggests that debate over U.S. international taxation will continue in Congress in 2005 and beyond. Some possible issues include: administrative aspects of the newly enacted AJCA; transitional aspects of AJCA's repeal of the extraterritorial income (ETI) export tax benefit; the place of international taxation in a possible movement towards fundamental tax reform; whether the United States should move towards a "territorial" tax system or — alternatively — adopt provisions designed to either promote tax neutrality or limit "offshore outsourcing."

This report will be updated as legislative and other developments warrant.

Contents

The United States in the World Economy	1
How Taxes Affect International Investment	3
Investment and the Distribution of Income	3
Taxes and Economic Welfare: Capital Export Neutrality, National Neutrality, and Capital Import Neutrality	4
U.S. Taxation of Foreign Income: The General Framework	6
Basic Jurisdictional Principles and the Foreign Tax Credit	6
The Foreign Tax Credit Limitation and Cross-Crediting	7
Deferral	8
Subpart F's Restriction of Deferral	9
The System's Overall Mix of Incentives	10
Domestic Provisions and International Investment	10
Recent Legislation: The American Jobs Creation Act of 2004 (P.L. 108-357) ..	11
Repeal of the ETI Benefit	11
Deduction for Domestic Production	12
Interest Allocation Rules	12
Consolidation of Foreign Tax Credit Baskets	13
Changes to Subpart F and Deferral	13
Possible Issues in 2005 and Beyond	14
Administration of the AJCA	14
Phase-Out of the ETI Benefit	15
Fundamental Tax Reform and International Taxation	15
Territorial Taxation	17
Taxes and Offshore "Outsourcing"	17

List of Tables

Table 1. Incentives Towards Foreign Investment Under the U.S. Tax System	10
---	----

U.S. Taxation of Overseas Investment and Income: Background and Issues in 2005

One of the chief manifestations of the increased openness of the U.S. economy is an increase in U.S. investment abroad. U.S.-based multinational firms are increasing their overseas operations; U.S. investors are increasing the foreign assets in their portfolios. This report analyzes how the current U.S. tax system applies to foreign investment undertaken by U.S. firms abroad, and how that application was changed by recent legislation. It also assesses the impact of the tax system and legislation, and concludes by discussing a variety of issues in international taxation that Congress may face in 2005 and beyond. It begins by setting the stage with a brief look at the data on international investment.

The United States in the World Economy

The most basic data clearly show that the U.S. economy is increasingly involved in the world economy. In the language of economics, the U.S. economy is growing more “open.” For example, the data show that the total volume of trade in goods and services, that is, exports plus imports, has increased substantially and steadily over the past 30 years. In 1971, exports plus imports were 10.8% of U.S. gross domestic product (GDP); by 2004 trade was a full 25.2% of GDP.¹

But the focus here is on capital investment, and if trade has increased substantially, investment has grown dramatically. Rough estimates indicate that in 1976, the stock of U.S. private assets abroad was 6.7% of the total U.S. privately-owned capital stock; by year end 2003, assets abroad were 18.7% of the total U.S. private capital stock. In 1976, the stock of foreign private assets in the United States was 3.7% of the U.S. capital stock; at year-end 2003 it was 27.0% of private U.S. capital.²

It is informative to take a closer look at the components of outbound investment. Traditionally, economists have identified two types of overseas investment: portfolio

¹ Data on trade are from U.S. Executive Office of the President, Council of Economic Advisors, *Economic Report of the President*, (Washington: GPO, February 2004), pp. 284, 312.

² The source for data on U.S. assets abroad and foreign assets in the United States is Patricia E. Abaroa, “The International Investment Position of the United States at Yearend 2003,” *Survey of Current Business*, vol. 83, July 2004, pp. 30-39. Data on the U.S. capital stock are from Paul R. Lally, “Fixed Assets and Consumer Durable Goods for 1925-2001,” *Survey of Current Business*, vol. 81, Sept. 2002, pp. 23-37. The fixed assets data were adjusted to include estimated stocks of inventory and intangible capital.

investment and direct investment. With portfolio investment, the underlying assets are not actively managed by the investor; direct investment entails the active management of overseas assets and operations by the investor. Portfolio investment can be thought of as a U.S. person or firm who has foreign stocks, bonds, or other assets in his investment portfolio; direct investment can be thought of as the overseas business operations of a U.S. firm. A striking conclusion emerges from the data: the rapid growth in U.S. assets abroad has consisted almost entirely of portfolio investment rather than direct investment in overseas business operations. At year-end 1976, portfolio investment abroad was 2.7% of the total U.S. capital stock; at the end of 2003, it was 13.1% of the total stock. In contrast, foreign direct investment was 4.1% of the total in 1976 and 5.6% at the end of 2003.

Taxes potentially affect investment by altering the allocation of capital between domestic and foreign locations; hence, our focus thus far on stocks rather than flows. However, another concern of international taxation is tax revenue. To obtain a rough idea of how important overseas investment potentially is to the U.S. tax base, it is useful to look at income flowing from international investment. Here, the growth in importance, while it has occurred, is somewhat less imposing. In 1976, receipts by private U.S. investors of earnings on overseas assets were 1.5% of U.S. GDP; by 2003, they were 2.6% of GDP. As with the stock of investment, most of the growth was in portfolio investment rather than direct investment. Over the same period, receipts from portfolio investment grew from 0.5% of GDP to 1.0% of GDP; receipts from foreign direct investment grew from 1.0% of GDP to 1.7% of GDP. Another way of gauging the importance of overseas investment income is to compare it with total U.S. income from capital. In 1976, private receipts from overseas investment were 7.1% of U.S. capital income; by 2003 they had grown to 8.5%.³

What is the import of these various numbers? First, they substantiate the notion that overseas investment has grown rapidly both in absolute terms and relative to the rest of the U.S. economy. Accordingly, U.S. tax treatment of that investment is potentially more important than previously; its various effects are increasingly important to the economy. We look next at how taxes can affect the allocation of investment between the domestic economy and foreign locations and the implications of those effects for several important dimensions of economic performance. Given portfolio investment's magnitude, U.S. tax policy towards investment in foreign stocks, bonds, and other portfolio assets is clearly important. The remainder of this report, however, focuses on overseas direct investment by U.S. firms — a topic that is frequently a focus of attention by Congress.

³ Data on receipts from foreign investment are from Douglas B. Weinberg and Kelly K. Pierce, "U.S. International Transactions, Third Quarter 2004," *Survey of Current Business*, vol. 85, Jan. 2005, p. 46. U.S. capital income data are from "BEA Current and Historical Data," *Survey of Current Business*, v. 84, Nov. 2004, p. D-16.

How Taxes Affect International Investment

If foreign investment is increasingly important, then the impact of tax policy on that investment is likewise more important. This first section of the report sets forth the basic economic analysis of how taxes in the abstract affect international investment. First, economic theory stipulates that a firm's fundamental goal is to maximize its profits — after taxes. And when a firm considers where to employ its investment, it implicitly weighs the relative rate of return on investment in its various locations — again, after taxes. Taxes can therefore pose an incentive for firms to invest overseas if the tax burden abroad is lower 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 if taxes are relatively high in overseas locations. 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 invest. The implication of this framework is clear: if U.S. and foreign tax systems as a whole were to favor either location over the other, then U.S. investment in the favored location would be higher than would otherwise occur. We defer discussion of the impact of particular features of the U.S. system until the next section, but note here that the overall thrust of the system is mixed in its incentive effects, with no clear net impact.

Simply to identify the likely impact of taxes on the allocation of investment is only an intermediate answer. According to economic theory, various important effects result from the allocation of investment between domestic and foreign sources, and it is these effects that are ultimately of concern to policymakers.

Investment and the Distribution of Income

One result of the allocation of investment capital is the distribution of income both within the United States and abroad. Thus, when taxes affect the allocation of investment between foreign and domestic uses, they also affect the distribution of income. Capital flows affect the distribution of income as follows: a basic principle of economic theory holds that in smoothly operating markets, labor compensation is commensurate with labor productivity; the more productive labor is, the higher wages are. Because labor productivity is higher the more capital it has to work with (the higher the capital/labor ratio), domestic labor income generally declines if capital income is diverted abroad. At the same time, income of domestic capital is increased if investors are free to seek higher returns abroad. In short, tax policy that increases or diminishes investment abroad has implications for the distribution of domestic income between capital and labor. This result likely underlies the contrasting policy recommendations for international taxes that tend to be supported by domestic labor, on the one hand, and multinational firms, on the other. In broad terms, labor tends to oppose tax measures that pose incentives to invest abroad; businesses tend to support them.

Taxes and Economic Welfare: Capital Export Neutrality, National Neutrality, and Capital Import Neutrality

Along with their impact on how income is distributed, taxes on capital flows have broad effects on economic efficiency or how much income is available for distribution in the first place. Economic theory has developed two standards for evaluating the efficiency of international taxation, each with a different perspective: “capital export neutrality” (CXN), which considers the impact of taxes on world economic welfare; and “national neutrality” (NN), which considers only the economic welfare of the capital exporting country (in this case, the United States). Discussions of international taxes also frequently evaluate them for their impact on the competitive position of U.S. firms abroad, a standard sometimes called “capital import neutrality” (CMN).

Capital export neutrality (CXN) is based on the idea that the economy’s supply of capital is employed most efficiently when each increment of capital is used where it earns the highest return, before taxes. In economic terms, this occurs when the pre-tax return on an additional increment of investment (“marginal” investment) abroad is equal to the pre-tax return on identical new domestic investment.

Generally, economics holds that in the absence of taxes, profit-maximizing investors will accomplish this allocation on their own, simply in response to market forces; they maximize their investment profits by ensuring that the return on additional investment abroad is just equal to the return on additional domestic investment. It follows that the most efficient tax system is that which least distorts investors’ decisions on how capital is employed. A tax system is thus most efficient when it is neutral towards the decision to invest at home or abroad, and when the tax burden on identical investments is the same in either location. CXN is a policy that establishes such conditions: a policy where taxes do not distort an investor’s decision of where to invest and the world’s capital resources are employed where they are most productive. Under CXN, the world’s economy is getting the most from its capital resources and world economic welfare is maximized.

A tax policy that maximizes world economic welfare by establishing identical tax burdens on foreign and domestic investment is not necessarily one that maximizes U.S. economic welfare. CXN, in other words, is not necessarily optimal from the perspective of the United States, and the United States alone. There are two reasons for this. First, a unit of capital that is employed in the United States increases both U.S. labor income and U.S. capital income: the labor component accrues because the unit of capital makes labor more productive and increases wages. In contrast, a unit of U.S. capital that is employed abroad produces a return for the investor but not for U.S. labor; the increase in wages accrues to foreign rather than domestic labor. As a result, national welfare is not maximized by equating the return to a marginal unit of capital abroad with a marginal investment in the United States. Instead, national welfare is maximized if overseas investment is discouraged by some incremental amount.

But even if U.S. labor were not directly disadvantaged by the shifting of investment abroad, neutral taxation would still not maximize U.S. economic welfare

in cases where foreign host governments impose their own tax on U.S. investors. This result occurs because the benefit to the United States of an additional unit of overseas investment is the return on that investment, less foreign taxes. The return on that same investment made in the United States, however, is the return on the investment plus any tax collected by the United States.

National neutrality (NN) is the term applied by economists to a tax policy that maximizes U.S. national welfare. In general, NN prescribes a tax burden on foreign investment that is higher than the burden on identical domestic investment so that investment abroad is discouraged. More specifically, NN at least prescribes a policy of allowing only a deduction for investors' foreign taxes and not a credit. Indeed, NN may well require an even more onerous tax rate on foreign investment. In general, the greater the demand for U.S. capital abroad, the higher the optimal tax rate under national neutrality. However, while NN maximizes U.S. welfare, it is a "beggar thy neighbor" policy that increases U.S. welfare by less than it reduces foreign welfare. Further, such a policy could redound to the disadvantage of the United States if foreign governments retaliated by restricting capital exports.

Multinational firms and others sometimes argue that tax policy towards foreign investment should be set so as to place U.S. firms on an even tax footing with foreign competitors — a standard sometimes referred to as "capital import neutrality (CMN)." Supporters of CMN generally argue that the standard could be achieved and U.S. competitiveness would be maximized if U.S. taxes did not apply to foreign-source income. Economic theory suggests that such a policy distorts the geographic allocation of capital and maximizes the economic welfare of neither the United States nor the world. Thus, even though it establishes even taxes when certain comparisons are made (i.e., U.S. firms compared to foreign firms), CMN is not a "neutral" policy in the same sense as CXN or NN.

Notwithstanding economic theory, a number of arguments are sometimes made in support of CMN. For example, it has been argued that given increasingly open and integrated world capital markets, U.S. savers desirous of investing in foreign equity can escape any U.S. corporate-level tax on overseas direct investment by means of portfolio investment, that is, by purchasing stock in foreign firms directly rather than relying on a U.S. multinational to make foreign investments for them.⁴ For this to be true requires portfolio investment to be a perfect substitute, in savers' eyes, for direct investment, which may not be the case. Beyond this, however, simply because savers can in some cases circumvent the U.S. corporate income tax on foreign direct investment is not a strong case against taxing foreign direct investment.

Another argument supporting CMN holds that overseas investment produces a higher return for research and certain other activities multinationals undertake; these activities carry with them "external" benefits to the economy as a whole that make the return to research greater than the private return to the firm conducting the

⁴ Daniel J. Frisch, "The Economics of International Tax Policy: Some Old and New Approaches," *Tax Notes*, April 30, 1990, pp. 590-591.

research.⁵ But while it is true that the external benefits from research suggest a subsidy is warranted, such a subsidy seems likely to be more accurately targeted if it were to apply only to research rather than foreign income. Further, the tax code already provides such a subsidy in the form of a tax credit and generous treatment of deductions for research.

Finally, it has been argued that if the supply of saving in the United States expands with reductions in tax on investment, then world welfare and U.S. welfare would be increased by cutting taxes on overseas investment as in CMN.⁶ This analysis, however, leaves unanswered the following question: if taxes on investment are to be cut, why reduce them in a manner that distorts the allocation of capital between the domestic economy and abroad?⁷

U.S. Taxation of Foreign Income: The General Framework

Relative tax burdens on foreign and domestic investment thus affect the allocation of investment between U.S. and foreign locations by posing incentives or disincentives to invest in either location. The allocation of investment, in turn, affects the distribution of income within the domestic economy and affects economic efficiency and economic welfare on international investment. Capital export neutrality, national neutrality, and capital import neutrality (CXN, NN, and CMN) are three standards or perspectives that are frequently used to gauge the nature of these effects in the case of a particular tax system or particular tax provisions. We look next at the basic features of the U.S. tax system and their effects.

Basic Jurisdictional Principles and the Foreign Tax Credit

Capital export neutrality prescribes equal tax burdens for identical new investment at home and abroad, and two basic jurisdictional elements of the U.S. system are (taken alone) consistent with CXN: taxation based on residence; and provision of a tax credit for foreign taxes paid. First the residence principle: conceptually, a home country can base its income tax jurisdiction either on who earns income or on the source of income. Under the latter, a country would confine its application of taxes to income earned within its own borders, operating a "territorial" tax system. Under the former, a country generally taxes the worldwide income of its citizens and residents, regardless of where the income is earned. Under its residence principle, the United States asserts the right to tax both the foreign and domestic

⁵ Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (Washington: Institute for International Economics, 1992), pp. 77-94.

⁶ Thomas Horst, "A Note on the Optimal Taxation of International Investment Income," *Quarterly Journal of Economics*, vol. 94, June 1980, pp. 793-795.

⁷ For an up-to-date and thorough review of economics literature on optimal taxation of foreign investment, see Donald J. Rousslang, "Deferral and the Optimal Taxation of International Investment Income," *National Tax Journal*, vol. 53, Sept. 2000, pp. 589-600.

income of its citizens and resident individuals and of corporations chartered in the United States (i.e., resident corporations).

Absent special provision, residence-based taxation would result in double-taxation of foreign income in any case where a foreign country imposes its own taxes. Like most countries in their role as a capital exporters, the United States accepts the responsibility for relieving double-taxation. In its case, the United States provides a foreign tax credit for foreign income taxes its residents pay on foreign-source income. In doing so, it concedes that the country that is host to overseas investment has first claim to tax that investment and first claim on the tax revenue it potentially produces.

As we shall see in a moment, additional features of the U.S. system prevent its achievement of full CXN. (Indeed, some would argue that the system falls substantially short of CXN.) But if residence taxation always applied under the system and all foreign income taxes were creditable, CXN would result. To see how, suppose first that the foreign tax rate on a U.S.-chartered corporation were low relative to the U.S. tax rate — we use a hypothetical foreign rate of 10% and assume the U.S. firm pays the maximum U.S. corporate rate of 35%. In this case, the firm would pay its foreign taxes at the 10% rate and use foreign tax credits to offset 10 percentage points of its pre-credit U.S. tax. The firm's total (U.S. plus foreign) tax on its foreign investment would consist of foreign taxes paid at the 10% rate plus 25 percentage points of U.S. tax (35% minus 10%) for a total of 35% — exactly the rate applicable to the firm's U.S. investment.

However, what if foreign taxes are higher than U.S. taxes? With an unlimited foreign tax credit, tax burdens on foreign and domestic investment would still be the same — foreign taxes not needed to offset U.S. tax on a foreign investment's own income could still be credited against U.S. tax on income from U.S. sources. The U.S. system, however, does contain a limitation that prevents this outcome.

The Foreign Tax Credit Limitation and Cross-Crediting

Under the U.S. tax code's foreign tax credit limitation, foreign taxes can only offset U.S. tax on the portion of a taxpayer's pre-credit U.S. tax liability that applies to foreign rather than domestic income. In effect, the tax code places a wall between foreign and domestic income, and once foreign tax credits have offset all U.S. tax on the foreign side of the barrier, any remaining foreign taxes cannot be credited. The extra foreign taxes become "excess credits" in tax parlance, and can be carried back up to one year and carried forward up to 10 years. (In contrast, a firm that has insufficient foreign taxes to offset its entire U.S. tax liability is said to have a "deficit" of foreign tax credits.) The purpose of the limitation is protect the U.S. tax base. Absent the limit, foreign host countries could in theory divert tax revenue from the U.S. Treasury by simply raising their own taxes on U.S. investors without fear of placing an onerous burden on the U.S. firms themselves.

Suppose, then, that a firm has no existing overseas investment and is contemplating a new project in a country with a high tax rate — say, a 50% foreign tax rate compared to the 35% U.S. tax rate. In this case, foreign tax credits could be counted on to eliminate all 35 percentage points of U.S. tax on the new investment's

income, but the remaining foreign tax — 50% minus 35%, or 15% of the investment's income — would not be creditable. The total tax on the foreign investment would consist of only the 50% foreign tax, but would be high relative to taxes on identical U.S. investment and would pose a disincentive to invest in the high-tax country.

As described above, NN is a policy perspective that recommends a disincentive to invest abroad, and so, in a sense, the limitation on the foreign tax credit introduces an element of NN into the U.S. system. The actual incentive situation, however, is complicated by the particular way in which the limitation is applied and by a practice known as “cross crediting.” Again, if a firm has no existing foreign investments, the foreign tax credit limit would result in a disincentive for high-tax foreign investments. But the tax code does not require the foreign tax credit's limitation to be calculated on an investment-by-investment basis or (similarly) on a per-country basis. Thus, if a firm is planning a new high-tax investment and has existing foreign investment that is lightly taxed (and thus subject to a residual after-credit U.S. tax liability), it can possibly cross-credit the excess foreign tax credits generated by the new, heavily taxed foreign against the existing, lightly taxed foreign investment. At the extreme, all excess credits produced by the new investment could be absorbed, reducing the tax burden on the heavily taxed foreign investment to a rate equal to the U.S. tax rate. Neutrality, in other words, can result, even for investment in high-tax foreign countries.

Cross crediting can also work where the new investment is in a low-tax rather than high-tax location, but in this case it produces a tax incentive for overseas investment. Here, a firm with existing heavily-taxed investment that produces excess credits can use the credits to offset the residual U.S. tax that would otherwise be due on new investment in a low-tax country. The excess credits, in effect, shield new investment in low-tax countries from new U.S. taxes, thus preserving the relatively low tax burden for investment in the low-tax country.

The ability of firms to cross-credit foreign taxes has been restricted at various times by the U.S. tax code in various ways although (as described below) the American Jobs Creation Act of 2004 (AJCA; P.L. 108-357) substantially relaxed these restrictions.

Deferral

An additional fundamental feature of the U.S. system is the so-called “deferral principle,” or simply deferral. If the U.S. tax jurisdiction is based on residence in a technical or legal sense, deferral is a substantial departure from residence (and towards territoriality) in economic substance. Deferral's impact is to shift the average impact of the system away from neutrality and in the direction of a general tax incentive for overseas investment.

Deferral works as follows: under the U.S. residence-based tax regime, corporations chartered in the United States are taxed on their foreign as well as domestic income. In contrast, the United States generally taxes foreign-chartered corporations only on income earned in the United States. Thus, where a U.S. parent firm invests abroad through a separately incorporated subsidiary firm chartered in a

foreign country, U.S. taxes do not apply to its foreign income as long as the income is reinvested abroad. U.S. taxes apply only when the income is repatriated to the U.S. parent firm as income or other income. U.S. taxes are, in other words, deferred or postponed. Because of a basic economic phenomenon known as discounting, taxes paid in the future do not matter as much to a firm as an identical amount paid in the present. And because of discounting, deferral results in a lower overall tax burden for foreign investment compared to domestic investment in cases where foreign taxes are relatively low. The low tax burden under deferral occurs regardless of whether a firm has excess credits available for cross crediting.

Since it results in a lower tax rate for investment in low-tax countries than for identical investment in the United States, it poses an incentive for investment in low-tax countries and nudges the U.S. system away from CXN. As noted above, CMN calls for the exemption of foreign income from U.S. tax. Under deferral, U.S. taxes ultimately apply when and if foreign earnings are repatriated, suggesting at least some difference between deferral and CMN. Nonetheless, deferral moves the system in that direction, and for income that is indefinitely reinvested abroad the difference between exemption and deferral is negligible.

Subpart F's Restriction of Deferral

Like most tax benefits, deferral has both critics and champions; the debate over its merits goes back four decades. The most significant curtailment of the provision, Subpart F, was enacted in 1962 as a compromise, after the Kennedy Administration initially proposed repealing deferral altogether. Subpart F singles out certain types of income and certain types of ownership arrangements, and in those cases taxes the income on a current rather than deferred basis.

Subpart F applies only to foreign corporations that the tax code classifies as Controlled Foreign Corporations (CFCs): foreign corporations that are more than 50% owned by U.S. stockholders. Further, it applies only to those U.S. shareholders whose stake in the CFC is 10% or greater. Subpart F applies its current taxation by requiring each 10% shareholder to include their share of a CFC's Subpart F income in their taxable income, even if it has not actually been distributed.

The types of income subject to current tax under Subpart F are generally those that are thought to be easily located in tax havens and low-tax countries: income from passive investment, that is, investment that is primarily financial in nature and that does not involve the active management of a business operation, and certain other types of income whose source is thought to be easily manipulated so as to locate it in countries with low tax rates. Passive investment income generally includes items such as dividends from small blocks of stock as well as interest and royalties. The other types of income in Subpart F include income from sales transactions with related firms, income from services provided to related firms, petroleum-related income other than that derived from extraction, and income from international shipping.

If deferral shifts the system towards CMN and away from neutrality and CXN, Subpart F — where it applies — mitigates deferral's effect.

The System's Overall Mix of Incentives

The framework we have described presents a patchwork of effects on relative tax burdens and a mix of incentives, disincentives, and neutrality that is perhaps bewildering in its complexity. We do not attempt a conclusion on the system's overall, average impact on investment; the system is not consistent with any one of the three policy perspectives of CXN, NN, and CMN. The following chart, however, is useful in at least identifying the circumstances in which each of the various incentive effects occur. As shown in the table, whether new overseas investment faces an incentive, a disincentive, or neutrality depends on whether the prospective investment is in a country with relatively high or low tax rates, and on whether a firm has existing investment that has generated excess credits.

Table 1. Incentives Towards Foreign Investment Under the U.S. Tax System

Investor's Foreign Tax Credit Position	Investment in High-Tax Countries	Investment in Low-Tax Countries
No Previous Foreign Investment	Disincentive	Neutrality (If deferral is not used) Incentive (if deferral is used)
Excess Credits	Disincentive	Incentive
Deficit of Credits	Neutrality	Neutrality (if deferral is not used) Incentive (if deferral is used)

Domestic Provisions and International Investment

The tax treatment of overseas investment does not work its incentive effects in isolation; it is the relative tax burden on foreign and domestic investment that matters to investors and that potentially changes the allocation of investment capital between the United States and abroad. Accordingly, investment tax incentives that are available for domestic but not overseas investment are at the same time disincentives to foreign investment. And prior to the Tax Reform Act of 1986 (P.L. 99-514), several broad investment incentives were available for domestic but not foreign investment, and thus posed such a disincentive. These provisions included the investment tax credit, which was available for domestic investment in plant and equipment and the Accelerated Cost Recovery System of generous depreciation deductions. The 1986 Act, however, repealed the investment credit and scaled back depreciation, leaving only a scattering of more narrow domestic incentives in place.

Notable among the still-existing incentives for domestic investment are the research and development (R&D) tax credit and two separate tax incentives for exporting. The R&D credit provides a tax benefit for firms that increase their

qualified research expenditures; “qualified research,” however, explicitly excludes research conducted abroad. The two export incentives are the “inventory source rule” and the extraterritorial exemption rules for exporters; they provide an incentive for domestic investment simply because exports — by definition — cannot be produced abroad. The inventory source rule provides an export incentive by allowing firms to allocate part of their export income abroad for foreign tax credit limitation purposes; the consequence of the allocation is potentially an effective exemption for a part of export income. The extraterritorial exemption likewise provides a partial exemption for export income; it is discussed in more detail below in the section on “competitiveness.” As described in the next section, however, the 2004 American Jobs Creation Act provides for the phase out of the ETI benefit over two years. At the same time, however, AJCA introduces a new tax incentive for domestic investment.

Recent Legislation: The American Jobs Creation Act of 2004 (P.L. 108-357)

The American Jobs Creation Act was enacted in October, 2004, and contained a variety of provisions affecting international investment. In one sense, the act’s changes were incremental — the act left the basic structure of the system and its fundamental elements and principles essentially intact. Further, the act did not change the basic incentive stance of the system, leaving intact the system’s presentation of a mixed variety of incentives, disincentives, and neutrality. Notwithstanding its incremental nature, however, a number of AJCA’s provisions were important; it might be argued that AJCA was the most significant legislation in the international area since the Tax Reform Act of 1986.

In broad terms, the act coupled repeal of the ETI tax benefit for exporting with a mix of tax benefits for domestic investment and overseas investment. The act also contained a set of revenue-raising provisions, generally consisting of restrictions on corporate tax shelters and tax-motivated corporate reorganizations known as “inversions.” In general terms, then, the act’s general impact on the incentive thrust of the U.S. system is similar to that of the U.S. system as a whole — its impact is mixed. Like the system in general, the act’s various provisions pose the full range of incentive effects on foreign vis-a-vis domestic investment, including items that enhance the attractiveness of foreign investment, others that favor domestic investment, and still others that promote neutrality among investment locations.

AJCA was a complex piece of legislation; its provisions were numerous both for international investment and domestic investment. The following list is far from comprehensive, but includes those provisions likely to have the largest impact on U.S. firms’ international investment decisions and indicates their likely impact.

Repeal of the ETI Benefit

The initial impetus for the act was a long-running dispute between the United States and the European Union (EU) over the U.S. extraterritorial income exclusion (ETI) tax benefit for exporting. The EU had filed a complaint with the World Trade

Organization (WTO) arguing that the ETI benefit was an export subsidy and thus violated the WTO agreements, which prohibit countries from providing export subsidies, either through tax benefits or by other means. A succession of WTO rulings supported the EU's complaint, and the WTO authorized the EU to impose up to \$4 billion in retaliatory tariffs on U.S. goods imported into the EU. The EU began to phase in its tariffs in March, 2004.

As discussed above, export subsidies pose a tax incentive for domestic over foreign investment; ETI's scheduled repeal thus will remove a domestic tax incentive.

Deduction for Domestic Production

For domestic investment, the bill contains a 9% tax deduction from income from domestic (and not foreign) production activities. The deduction applies to corporations and non-corporate businesses alike. To illustrate its effect, for a firm in the top corporate tax bracket of 35%, the deduction will have an effect similar to a reduction in the tax rate to 31.85% (i.e., $35\% \times [100\% - 9\%]$).

Because the deduction is restricted to domestic investment, the deduction (in isolation) poses an incentive for firms to invest in the United States rather than abroad. In this respect, the deduction is akin to the repealed ETI benefit and was, in fact, partly intended to compensate for the economic impact of ETI's repeal. In contrast to the repealed ETI benefit, however, the incentive is not confined to investment in the domestic export sector.

Interest Allocation Rules

The prior section outlining the structure of the U.S. system highlighted the importance of the foreign tax credit's limitation in determining a multinational's after-credit tax liability and in setting the pattern of incentives and disincentives facing U.S. investment abroad. Again, the limitation restricts foreign tax credits to offsetting U.S. tax on income from foreign rather than domestic sources. The limitation's formulation results in great importance for the tax code's rules for determining the source of income. And since the limitation is in terms of net, taxable, income, rules governing the source of deductions are just as important as rules governing the allocation of gross income.

An important provision of AJCA was revision of the rules governing the allocation of interest expense. Under both prior and current law, U.S. Treasury regulations require interest on a taxpayer's borrowing in the domestic economy to be allocated between U.S. and foreign sources, based on the idea that debt is "fungible" — that is, each increment of debt helps finance all of a firm's investment, foreign and domestic.

Prior to AJCA, interest expense was allocated based on a "water's edge" method, which had two important features. First, only the interest of U.S. parent firms was allocated between sources — that is, while some of a parent's interest expense could be allocated to foreign sources, none of a foreign subsidiary's expense

was allocated to U.S. sources. Second, interest was allocated between domestic and foreign sources in proportion to the share of a parent firm's assets in each location. Under this method, a parent firm's equity stake in a foreign subsidiary was included in the calculation, but the foreign subsidiary's debt-financed investment was not.

AJCA modified these two features, including subsidiaries' interest expense in the allocation formula as well as subsidiaries' debt-financed assets. In isolation, the first of these changes reduced the allocation of interest abroad (resulting in a tax cut) while the second increased foreign allocations (resulting in a tax increase). The first effect, however, is the larger, and AJCA's modifications resulted in a tax cut for firms subject to the foreign tax credit limitation. The incentive effect of the change, however, is to increase a disincentive to foreign investment posed by the allocation rules.

Consolidation of Foreign Tax Credit Baskets

The discussion of the foreign tax credit in the preceding section described how the credit's limitation helps present in some cases a tax disincentive for foreign investment, but cross-crediting ameliorates the effect, sometimes converting the disincentive into neutrality or converting neutrality into a tax incentive. (See the chart on page 10.) At times in the past, the U.S. tax code has contained features that restricted cross crediting. In the 1950s, for example, firms were required to calculate their foreign tax credit limitations on a country-by-country basis.

More recently, the Tax Reform Act of 1986 (P.L. 99-514) sought to reduce instances where cross-crediting could occur by requiring that the foreign tax credit limitation be applied separately for several different types of income or "baskets." The segregated types of income were generally of a sort whose source is thought to be easily manipulated as well as income that is characteristically subject to either a high foreign tax rate or a low foreign tax rate. The baskets, in short, were meant to separate income that lends itself particularly well to the cross-crediting of foreign taxes. Prior to AJCA, a partial list of the specific separate baskets included income from passive investment; income subject to high foreign withholding taxes; financial services income; and shipping income. AJCA consolidated the separate baskets into two: one for passive investment income and one for all other income. In isolation, the consolidation expands the range of foreign investments that can benefit from cross-crediting, switching the position of some investments from a disincentive to neutrality or a reduced disincentive and the position of others from neutrality into an incentive.

Changes to Subpart F and Deferral

AJCA contained several changes to deferral and Subpart F, although these were likely not as important as the act's foreign tax credit provisions. In general, the modifications expanded deferral by making incremental restrictions in the scope of Subpart F. In terms of revenue impact, AJCA's largest alteration in the deferral structure is a temporary, one-year 85% deduction for earnings repatriated to U.S. parent firms from foreign subsidiaries during the one-year period. (The deferral principle is only a postponement of tax, not a permanent exemption; U.S. taxes

ultimately apply when income is repatriated. The AJCA provision thus reduces the tax burden on repatriations.) Supporters of the provision have argued that the deduction will stimulate investment in the United States because it will encourage firms to repatriate earnings that would otherwise have been reinvested abroad. Economic theory, however, is skeptical of this outcome. While the deduction may have little impact on investment while it remains temporary, it may actually increase the incentive to invest abroad if it becomes permanent.

Another AJCA provision provides more generous treatment of partnership interests under Subpart F, and a third provision removes international shipping income from Subpart F's coverage. In isolation, each of these provisions likely increases firms' incentive to invest abroad.

Possible Issues in 2005 and Beyond

Based on the discussion in the preceding sections, this is where the U.S. international tax system stands at the outset of 2005. First, U.S. international taxation is increasingly important. As part of an increasingly open economy, U.S. investment abroad is growing; the manner in which it is taxed is thus increasingly important. Second, the U.S. tax system presents a patchwork of incentives, disincentives, and neutrality towards the decision to invest abroad; different parts of the system are consistent with different policy standards: CXN, NN, and CMN. Third, in 2004 the AJCA implemented a set of provisions that also presented a variety of incentive effects; some of the changes, while incremental, were nonetheless important. It might be argued that the mixed nature of the basic system's effects reflect an ambivalent attitude by policymakers and the public alike towards international taxation. The mixed nature of the AJCA echoed that ambivalence, and suggests that there is no consensus on which policy standard U.S. international taxation should support.

What does this context predict as international tax issues that may arise in 2005? In abstract, general terms, the hybrid nature of the U.S. system suggests debate over the appropriate course for U.S. policy may continue through 2005. In more specific terms, a number of possible issues suggest themselves, and we provide brief discussions of them here. The first two are near-term and specific in nature, and are suggested by the comments of policymakers and tax professionals in the closing weeks of 2004 and the first weeks of 2005. The list then moves on, however, to more general and conceptual issues that are suggested — in part — by the preceding discussion of policy perspectives and how those perspectives evaluate the U.S. system.

Administration of the AJCA

The 2004 AJCA was an exceedingly complex act, and the process of putting its provisions into effect will pose issues that may capture congressional attention in 2005. A number of the act's tax cuts apply only to particular types of income, or to activities that meet a particular set of definitions, and working out precisely how those types of income and activities are to be identified may prove difficult. Perhaps

chief among the potential administrative difficulties is AJCA's new domestic production deduction, and the task of distinguishing qualifying income from that which is not eligible for the benefit.⁸ A second possible source of administrative difficulty is the reduced tax rate for repatriated dividends — an issue of near-term importance because the provision's one-year window applies to taxpayers' first tax year after AJCA's enactment. Under the act's provisions, repatriated dividends do not qualify for the rate reduction if they are used for certain purposes — for example, for the payment of dividends on the U.S. parent's stock or to buy back the parent's stock from shareholders. An early issue with the repatriation reduction is reportedly how to distinguish repatriations that qualify for the deduction under these terms from those that do not.⁹

Phase-Out of the ETI Benefit

A succession of WTO panel decisions supported the European Union's (EU's) complaint that the U.S. ETI benefit was an export subsidy and thus prohibited under the WTO agreements; the WTO also authorized the EU to impose up to \$4 billion in tariffs on U.S. products. The EU began to phase in its tariffs in March, 2004, but in view of the U.S. repeal of ETI suspended its tariffs on January 1, 2005. However, the EU has expressed dissatisfaction with the transition rules that accompanied ETI's repeal. Rather than ending immediately, the benefit is gradually phased out over two years. Further, the benefit is still applicable (is "grandfathered") for certain existing contracts. The EU has begun a fresh complaint process based on AJCA's transition rules, and if the WTO rules against the United States, the EU has indicated it may reimpose its retaliatory tariffs.¹⁰ Thus, Congress may again consider the ETI issue in 2005.

Fundamental Tax Reform and International Taxation

The Bush Administration has stated that consideration of fundamental tax reform will be a policy priority in the Administration's second term. A variety of general arguments have been advanced to support tax reform — for example, that it will simplify the tax system, promote economic efficiency, and stimulate economic growth. In addition, one type of broad tax reform — switching from the current hybrid tax system to a tax on consumption — has been advocated in part because of its perceived favorable effect on U.S. economic competitiveness. Economists are generally skeptical of such claims (and even of the value of "competitiveness" as a concept), but it is nonetheless likely that if tax reform is given serious consideration in Congress, its international dimension is likely to be thoroughly debated.

⁸ See, for example, the remarks of the Joint Tax Committee's chief of staff, as reported in Kenneth A. Gary, "Jobs Creation Act Brings Budget, Administrative Hurdles, Says Yin," *Tax Notes*, Nov. 8, 2004, p. 789.

⁹ Robert Willens, "Investors Face Disappointment with IRS's Section 965 Guidance On Permissible Uses of Funds Repatriated from Foreign Subsidiaries," *BNA Daily Tax Report*, Jan. 18, 2005, p. J-1.

¹⁰ Gary G. Yerkey, "EU Open to Further Talks with U.S. in Dispute Over Tax Breaks for Exporters," *BNA Daily Tax Report*, Jan. 18, 2005.

First, if reform takes the form of a consumption tax, what might be its principal effects in the international sector of the economy? Proponents of a national sales tax or of a value-added tax (VAT) sometimes argue that U.S. exports will be increased because — as with the VATs used by European and other foreign countries — the tax will be rebated for exports and levied on imports. Yet while these so-called “border tax adjustments” are part of several of the most fully-articulated reform proposals, this is one area where economists doubt the impact of moving to a consumption-based tax: economic theory indicates that because of adjustments in exchange rates or other mechanisms, border tax adjustments ultimately do not alter a country’s balance of trade.

But movement to a consumption tax could potentially implement large and important changes in the U.S. tax system and could have important effects in the international sector. For example, while taxes are an ineffective tool for changing the trade balance, they can (and likely do) affect the composition of imports and exports. Thus, if tax reform entails a shift in the way taxes apply across products, it could alter what the U.S. economy imports and what it exports.

A shift to a consumption tax would likely alter the comparative tax burden on domestic compared to foreign investment. Under a consumption tax, the return on new domestic investment would be exempt from U.S. tax, while under the most prominent proposals made in past years, foreign-source income would be outside the U.S. tax jurisdiction. As a result, new U.S. investments would face a relatively low tax burden compared to investment abroad, which would continue to face corporate taxes imposed by foreign governments. Thus — except in jurisdictions with no taxes of their own — U.S. firms would face a tax incentive to invest in the United States rather than abroad.¹¹ As a cautionary note, however, some analyses have concluded that shifting to a consumption tax may reduce domestic real interest rates even if such a tax were revenue neutral. In isolation, this would have an effect in the opposite direction of the direct impact of relative domestic and foreign tax burdens.

While some have proposed that fundamental tax reform take the specific form of a tax on consumption, that outcome is not a foregone conclusion. Alternatively, tax reform could take the form of a comprehensive income tax — that is, a tax that applies to all income from all sources and that does not contain the myriad of exemptions, deductions, and credits provided by current law. In the international area, movement towards a comprehensive income tax would likely entail repeal of deferral and implementation of separate foreign tax credit limitations for the various types of foreign income or for income earned in each foreign country. With respect to investment in low-tax countries, such a system would be consistent with CXN but would be more in accord with NN with respect to investment in high-tax countries.

¹¹ Note that the CXN-NN-CMN framework has limited use as an analytical framework under a consumption. In this way, the consumption tax is similar to the AJCA’s new domestic production deduction. While it poses an incentive for domestic investment, it is in contrast to traditional prescriptions for NN in that the shift to domestic investment would occur because of a tax cut for domestic investment rather than a tax increase for investment abroad; the benefit of the shift would thus likely principally accrue to domestic capital rather than labor.

Territorial Taxation

In a legal sense, the current U.S. tax system bases its jurisdiction to tax on residence — that is, the United States taxes U.S. resident corporations and individuals on their worldwide income, regardless of its source. An alternative jurisdictional concept is territoriality, in which jurisdiction to tax is based on the source of the income in question rather than the nationality of the individual or firm earning the income. Under a territorial tax system, a country taxes income earned within its borders but exempts foreign-source income. Among major U.S. trading partners, France and the Netherlands have territorial systems.

A territorial tax would be consistent with the principle of capital import neutrality described above. Multinational firms and investors have frequently supported territorial taxation, or at least a movement in that direction, if not for reasons that explicitly have CMN in mind, then to promote U.S. “competitiveness.” Some have argued, for example, that as the U.S. economy becomes increasingly open and U.S. firms increasingly compete in the global marketplace, the tax system should be modified to promote U.S. firms’ competitiveness. While the net, overall thrust of the 2004 AJCA on incentives towards overseas investment was, as described above, mixed, its contraction of Subpart F and consolidation of foreign tax credit baskets can nonetheless be viewed as incremental movements in the direction of territoriality. It is thus possible that the 109th Congress will consider legislation that continues to move the system in that direction.

Taxes and Offshore “Outsourcing”

A high-profile topic of debate in 2004 was offshore outsourcing — generally, the real or perceived movement of jobs from the United States overseas.¹² A principal way taxes are thought to abet what is sometimes described as the “export of jobs” is by encouraging U.S. firms to invest abroad, and to establish foreign operations rather than operations in the United States. As described above, deferral and in some cases cross-crediting poses an incentive for overseas investment.

The policy prescription of those concerned with offshore outsourcing is to at least eliminate the tax system’s extant incentives for investment abroad — a prescription that is consistent with capital export neutrality. However, the focus of outsourcing’s opponents on the movement of capital abroad and on outbound investment’s employment effects also suggest sympathy with the principle of national neutrality, which, as described above, would go beyond mere neutrality and would implement a tax policy designed to dampen overseas investment.

¹² For additional information on taxes and outsourcing, see CARS Report No. RL32587, *Taxes and Offshore Outsourcing*, by David L. Brumbaugh.