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U.S. International Corporate Taxation: Basic Concepts and Policy Issues

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Contents

Introduction.....	1
Worldwide Versus Territorial Taxation	1
Deferral, Subpart F Income, and Active Financing	2
The Foreign Tax Credit.....	3
Cross-Crediting.....	4
Profit Shifting	5
Base Erosion and Profit Shifting (BEPS) Action Plan.....	6
Making Tax Rate Comparisons.....	7
Competition Versus Trade.....	7
Summary and Related Readings	8

Contacts

Author Contact Information.....	9
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Introduction

Recent deficit reduction and tax reform plans have included broad proposals to reform the U.S. international corporate tax system. These proposals have raised concerns over how changing the way American multi-national corporations are taxed could impact the deficit and debt, domestic job markets, competitiveness, and the use of corporate tax havens, among other things. An informed debate about how to reform the system governing the taxation of U.S. multi-national corporations requires careful consideration of these issues, as well as a basic understanding of several features of the current system.

This report provides a general introduction to the basic concepts and issues relevant to the U.S. international corporate tax system. The explanations provided in this report emphasize the underlying concepts of the international tax system and are intended to be as simplified as possible. There are of course important and complex technical details that would need to be considered carefully if reform of the current system were to be implemented effectively and efficiently. These important technical details, however, are beyond the scope of this report. Where appropriate, references to other CRS products are provided within the report. A list of related CRS products and other suggested readings on international corporate taxation may also be found at the end of the report.

Worldwide Versus Territorial Taxation

The United States taxes American corporations on their worldwide income.¹ This approach to taxation is referred to as a worldwide (or resident-based) tax system. Examples of other countries that take this general approach include Chile, Ireland, Mexico, and South Korea. The most commonly used alternative to the worldwide tax system is known as a territorial (or source-based) system. If the United States were to employ a territorial tax system, it would tax American corporations only on the income they earned within the physical borders of the United States. Countries that have adopted a territorial type system include Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Italy, Japan, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, and the United Kingdom, among others.²

In reality, no country has either a pure worldwide or a pure territorial tax system. In a pure worldwide tax system a country would allow domestic corporations to claim a full credit for foreign taxes paid, although no country allows this. In a pure territorial tax system a country would completely forgo taxing any of the income earned abroad by domestically based

¹ The concepts discussed are described and analyzed in greater detail in CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by (name redacted).

² Categorization of worldwide versus territorial type system was based on Ernst & Young, *Briefing: Corporate income tax (CIT) rates*, 2014, <http://www.ey.com/GL/en/Services/Tax/Tax-policy-and-controversy/TPC-Briefing—Corporate-income-tax—CIT—rates>, and Pricewaterhouse Coopers, *Evolution of Territorial Tax Systems in the OECD*, April 2, 2013, p. 3, http://www.techceocouncil.org/clientuploads/reports/Report%20on%20Territorial%20Tax%20Systems_20130402b.pdf. There are some discrepancies between these two sources. For example, Poland is categorized by PWC as having a territorial system, but as having a worldwide system by E&Y. The converse is true for Israel. Aside from Ireland, which was only categorized by PWC, only those countries that were consistently categorized across both sources were included here. Also see U.S. Congress, Joint Committee on Taxation, *Background And Selected Issues Related To The U.S. International Tax System And Systems That Exempt Foreign Business Income*, 112th Cong., 1st sess., May 20, 2011, JCX-33-11 for more detail on other country's territorial based systems.

corporations; however, every country taxes some amount of corporate income earned abroad. Pure forms of either system would likely limit the ability to address abusive tax evasion practices and would result in other countries changing their tax systems for their own benefit.³ Thus, in practice the distinction between having a “worldwide” or “territorial” tax system is generally one of degree.

Still, the pure-form systems each have an important property that serves as a point of departure in the international tax reform debate. A pure worldwide tax system exhibits what is known as “capital export neutrality,” which states that taxes should be irrelevant to a corporation’s decisions to invest at home or overseas (i.e., export capital). Wherever a corporation locates their investment (production facility, manufacturing plant, etc.), they face the same tax on the resulting income. In theory, this should lead corporations to allocate their capital to its most productive use in the *world* economy. In addition, global economic output (income) will be maximized if all other countries use a worldwide system since foreign corporations will similarly allocate their capital to its most productive use in the world economy.

A pure territorial system exhibits what is known as “competitive neutrality,” also known as “capital import neutrality.” With a pure territorial system, corporations making overseas investments face the same tax rates as foreign competitors in foreign markets. This, in theory, should remove any tax-based competitive disadvantage of corporations in foreign markets. For example, consider an American car maker and a Japanese car maker, both with production facilities in Japan. With a territorial system, the two car makers would both pay the same in total taxes on the income earned in Japan. The American and Japanese car makers would be competitively neutral with respect to taxes as a result. This system is not neutral in an economic sense, however, because it causes more investment in low-tax countries than would occur without taxes.

A third concept of “neutrality” that is often referenced in the worldwide versus territorial debate is known as “national neutrality.” National neutrality corresponds to a worldwide tax system with a deduction for foreign taxes paid instead of a full tax credit. Allowing a deduction instead of a credit decreases the after-tax return to investing abroad relative to investing at home and results in more domestic investment and corporate income than with a pure worldwide system. Additionally, a deduction is less costly to the government than a credit, so government tax revenues are higher. As a result, total national income is maximized assuming foreign countries do not change their tax rules in response.

Deferral, Subpart F Income, and Active Financing

While the United States has a worldwide-based tax system, current law allows American corporations with foreign subsidiaries to defer paying taxes on income earned abroad until that income is repatriated (returned) to the United States.⁴ This represents a benefit to American corporations, which, all else equal, prefer to pay taxes later rather than sooner. In the extreme, deferral could allow an American corporation to completely avoid U.S. taxation if they never

³ There is an important legal distinction between tax avoidance and tax evasion. Tax avoidance refers to the use of all legal tax practices to lower ones tax liability. Tax evasion refers to illegal tax practices to lower ones tax liability.

⁴ Repatriation is technically accomplished via a dividend payment from a foreign subsidiary to its American parent corporation.

repatriate their overseas income. The income earned by foreign branches of American corporations, however, is not deferrable.⁵

A particular type of income which does not qualify for deferral is “subpart F income.” Named for the location in the Internal Revenue Code where its tax treatment is defined, subpart F income generally includes passive types of income such as interest, dividends, annuities, rents, and royalties.⁶ The highly fungible nature of subpart F income is such that corporations can use overseas subsidiaries to transfer taxable income from high-tax countries to low-tax countries with the ultimate goal of reducing their U.S. income tax liability. To prevent this, corporations must pay taxes on subpart F income in the year it is generated, regardless of whether it is actually repatriated to the United States.⁷

An important exception to the subpart F income tax rules exists for “active financing income.” The active financing exception relates to the income earned by American corporations that operate banking, financing, and insurance lines of business abroad. Although some of the income derived from these lines of business (e.g., interest, dividends, and annuities) could be labeled as passive, they are excepted from subpart F if the income was generated as a result of active business operations. On the one hand, there is the argument that there are real economic rationale for keeping this income abroad and that transactions involving active financing income are not necessarily for tax avoidance purposes. On the other hand, it could be argued that passive income is passive income, regardless of the underlying line of business. Nonetheless, active financing income qualifies for deferral and is only taxed when it is repatriated to the United States.

The Foreign Tax Credit

When American corporations repatriate income from subsidiaries operating abroad, that income may have already been taxed by a foreign country. If it has, corporations are generally allowed to claim a dollar-for-dollar tax credit (up to a limit) for foreign taxes paid. The credit, formally known as the foreign tax credit, is intended to alleviate the double taxation of corporate income.⁸ The credit is generally limited to the amount of taxes a corporation would pay in the credit’s absence, which is effectively just the U.S. corporate tax rate multiplied by the amount of income earned abroad. In other words, an American corporation may claim the foreign tax credit up to the point that the credit reduces its U.S. tax on foreign-earned income to zero, but no further. Additionally, a separate credit must be calculated for two types of income “baskets”—passive and non-passive income.

As long as the U.S. corporate tax rate is higher than the foreign county’s rate, the foreign tax credit should—in principle—result in the corporation owing the same amount in total taxes (U.S.

⁵ A foreign subsidiary is a legal entity separate from its parent company, while a foreign branch is an extension of a domestic company.

⁶ Specifically, the tax treatment of subpart F income may be found in Sections 951 to 956 of the IRC.

⁷ A rule called “check-the-box” has undermined subpart F provisions by allowing foreign subsidiaries to make transactions between themselves, such as loans and royalty payments, which are not recognized as taxable transactions by law. With check-the-box a corporation can set up a foreign subsidiary that owns another a foreign subsidiary. The company then “checks a box” on an IRS form choosing to have the lower level subsidiary treated as a disregarded (fiscally transparent) company for tax purposes. Transactions between the two subsidiaries are then treated as if they are occurring within the same company, avoiding the subpart F anti-deferral rules.

⁸ Sections 901 to 909 of the IRC define the foreign tax credit rules.

plus foreign) as it would if it earned the income in the United States. When the foreign tax rate is higher than the U.S. tax rate, a corporation will end up paying total world taxes (U.S. plus foreign) at the higher foreign rate. Additionally, in such a circumstance the corporation could end up with “excess” foreign credits because of the limits that restrict the credit from reducing U.S. taxes owed below zero.

An example may help in understanding the mechanics of the foreign tax credit. Consider an American corporation that pays taxes in the United States at the top corporate rate of 35%, and that has a subsidiary located in a country with a 25% tax rate. If the corporation earned \$100 of income abroad, it would pay \$25 in foreign taxes. When the corporation repatriates this income it would initially owe \$35 in U.S. taxes. Before actually paying this tax, however, the corporation could claim a foreign tax credit of \$25, reducing its U.S. tax liability from \$35 to \$10. Notice that this corporation pays a total of \$35 in taxes worldwide, corresponding to a 35% world tax rate on foreign earned income.

The example above assumes that the foreign tax rate is lower than the U.S. tax rate, which need not be the case. Consider the case where the foreign tax rate is 45% instead of 25%. The corporation would pay \$45 in foreign taxes on the \$100 of income earned abroad. When the corporation repatriates this income it would still initially owe the United States \$35 in taxes. This time, however, the corporation’s available \$45 in foreign tax credits exceeds its U.S. taxes owed. As a result, the corporation could use its \$45 in foreign tax credit to reduce its \$35 U.S. tax liability to zero, leaving it with \$10 in “excess” credits. Notice that this corporation pays a total of \$45 in taxes worldwide, corresponding to a 45% world tax rate on foreign earned income. The next section discusses how firms can use excess credits from one country to offset earnings from another country.

Cross-Crediting

Cross-crediting refers to American corporations applying excess foreign tax credits generated in a high-tax country to U.S. tax owed on income generated in a low-tax country. This is possible because deferral allows corporations to selectively decide when to repatriate income and therefore when to use excess credits. By choosing to repatriate income from low-tax countries when excess foreign tax credits exist, corporations can lower the amount of U.S. tax they would otherwise have to pay. In essence, this practice allows corporations to use tax credits related to one source of income (from high-tax countries) to offset taxes on unrelated income (from low-tax countries). This could be argued to go against the relief of double taxation objective of the foreign tax credit. Corporations, however, are not allowed to use excess credits associated with passive income to offset taxes on active income, or vice versa.

Mechanics of Cross-Crediting		
	Low-Tax Subsidiary	High-Tax Subsidiary
Earnings:	\$100	\$100
Foreign taxes paid:	\$10	\$45
U.S. taxes owed:	\$35	\$35
U.S. taxes after credit:	\$25	-\$10
U.S. taxes paid:		\$15

To understand the basic mechanics of cross-crediting, consider another example. Suppose an American corporation has two foreign subsidiaries, each earning \$100. One subsidiary is located in a low-tax country and pays \$10 in foreign taxes (10% tax rate), and the other is located in a high-tax country and pays \$45 in foreign taxes (45% tax rate). When the corporation repatriates the foreign-earned income of its subsidiaries it will initially owe \$35 in U.S. taxes for each one (35% tax rate). The corporation can apply the high-tax country subsidiary's \$45 foreign tax credit to that subsidiary's \$35 U.S. tax liability, leaving it with \$10 in excess credits. The corporation can then apply the low-tax country subsidiary's \$10 foreign tax credit to that subsidiary's \$35 U.S. tax liability, leaving it with \$25 in U.S. taxes still due. Finally, the corporation can cross-credit the \$10 in excess credits from the high-tax subsidiary and reduce the low-tax subsidiary's final U.S. tax liability from \$25 to \$15. The result is the corporation pays less in U.S. taxes than if cross-crediting were prohibited.

Profit Shifting

Profit shifting generally refers to corporations artificially moving taxable income from high-tax countries to low-tax countries as part of a tax reduction strategy. A popular method used to accomplish this is debt shifting. By financing operations in high-tax countries with debt and financing operations in low-tax countries with equity (e.g., stock), corporations are able to deduct interest in countries where the deduction is most valuable and have income taxed in countries with the lowest rates. At the same time, the overall capital structure of the corporation (its mix of debt and equity) may remain the same, indicating the financing strategy was tax motivated. Debt shifting can also involve the use of intercompany loans made between different parts of the company located in high-tax and low-tax countries. The ultimate goal is to claim interest deductions in high-tax countries and pay income in low-tax countries.⁹ What are known as “thin” capitalization rules have been enacted in the United States and abroad to limit this strategy, but it continues to be utilized.

Another popular method used to shift profits involves intracompany transfers of intangible assets and intellectual property such as patents, copyrights, trademarks, trade secrets, etc. For example, an American corporation may form a subsidiary in a low-tax country and then sell the rights to use an intangible asset to it. A subsidiary of the same American corporation, but located in a high-tax jurisdiction, may then lease the right to use the intangible asset from the low-tax subsidiary. In exchange, the high-tax subsidiary would pay the low-tax subsidiary a royalty payment, perhaps at a markup. The royalty payment would reduce the taxable income of the high-tax subsidiary and simultaneously shift profits to the low-tax subsidiary.

A third strategy favored by corporations to shift profits involves charging prices that do not reflect market, or “arm's length,” prices for goods transferred between subsidiaries. For example, a subsidiary in a low-tax country could overcharge a subsidiary in a high-tax country for a particular product. This would allow the high-tax subsidiary to claim a higher than normal deduction for the payments to the low-tax subsidiary, while also allowing the low-tax subsidiary to realize the payments as income. The United States and other countries have established what are known as transfer pricing rules that are intended to insure that transactions between related

⁹ For a more detailed deduction of profit shifting and tax havens, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by (name redacted).

subsidiaries occur at market prices. Difficulty arises, however, when no clear market price exists, for example, with something such as intangible property.

Often times multiple tax planning strategies, such as the ones described above, are used in conjunction to minimize taxes. Several layers of subsidiaries operating in multiple countries may also be involved. Additionally, instead of these transactions occurring just between subsidiaries, they may occur between the U.S. parent corporation and a foreign subsidiary. The explanations provided here are for simplicity and it should be noted that analyzing and understanding the specific tax strategy used by a particular company can be extremely complex.¹⁰

Base Erosion and Profit Shifting (BEPS) Action Plan

Growing concern at home and abroad over the methods used by multinational corporations—both U.S. and foreign—to avoid or delay paying taxes has led to calls for a coordinated effort to reduce profit shifting. As a result, the Organisation for Economic Co-operation and Development (OECD) has initiated development of an Action Plan on Base Erosion and Profit Shifting (BEPS) at the request of the G20 Finance Ministers.

The goal of the BEPS project is to develop 15 detailed actions governments can take to reduce tax avoidance by multinational corporations (as well as individuals) worldwide. The Action Plan is scheduled to be completed in three phases: September 2014, September 2015, and December 2015. Some of the actions will require coordination and information sharing between governments, and potentially the amendment of existing tax treaties. As a result, the Action Plan relies heavily on the participation of all major economies. A number of G20 countries that are not part of the OECD (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, and South Africa) participated in the meetings that led to the eventual adoption of the Action Plan by all G20 finance ministers.

The OECD has been careful to stress that many of the strategies used by multinational corporations are likely legal. One reason corporations can move profits from high-tax to low-tax countries is the antiquated designs of international tax regimes. Current tax systems were not designed to handle highly mobile intellectual property and intangible assets. Patents, trademarks, and algorithms can be easily moved from one country to another with little or no change in real economic activity, taking with them the income they generate. Additionally, differences and lack of coordination between nations' tax systems can provide opportunities for companies to engage in tax minimization strategies. Lastly, there are various items in countries' tax codes and regulations that provide preferential tax treatment to certain income earned abroad, or that provide the opportunity for legal maneuvering. Some of these items were the result of intentional policy choices, others were not.

¹⁰ For a specific example, see Edward D. Kleinbard, "Through a Latte Darkly: Starbucks' Stateless Income Planning," *Tax Notes*, June 24, 2013, pp. 1515-1535.

Making Tax Rate Comparisons

One of the main focal points in the debate over corporate tax reform is whether the top U.S. federal corporate tax rate of 35% is too high relative to the rest of the world.¹¹ This often referenced rate is the top *statutory* federal tax rate, defined as the legally imposed rate on taxable income. In many countries, including the United States, non-federal governments (e.g., states) also levy a corporate income tax, which increases the total statutory rate corporations face. Regardless, because of a number of tax subsidies (deductions, credits, exemptions, etc.) in the corporate tax system, corporations' *effective* (or actual) tax rate is typically less than the statutory rate. The United States is not alone in having effective rates that differ from statutory rates. It is therefore more appropriate to look at total effective tax rates when comparing the United States to the rest of the world.¹²

It is also important to keep in mind that effective rates can vary substantially among U.S. corporations and across corporations in the same industry, complicating a general U.S. to rest-of-the-world comparison. For example, some corporations rely more on debt financing, which is tax preferred to equity financing, reducing their effective tax rate. Some corporations and industries rely more on machines and facilities that can be depreciated (“written-off”) more quickly than assets in others industries, which again leads to differing effective tax rates. Other corporations and industries have more extensive overseas operations, which affects their effective U.S. tax rate. In the end, an American corporation or an entire domestic industry could face a higher or lower (or the same) effective tax rate than a foreign competitor—there is no one single effective tax rate that applies to all American corporations.

Finally, when making comparisons between U.S. and worldwide tax rates it is important to indicate whether tax rates are simple (unweighted) averages or whether they are adjusted (weighted) to account for the size of the economies being compared. If the U.S. tax rate is compared to world tax rates that are not weighted, then a small economy, such as Iceland, can have the same effect on the average international rate as a large economy, such as Germany or Japan. It is therefore more appropriate to compare the U.S. tax rate to an weighted average of international tax rates. Typically, each country's tax rate is weighted by its gross domestic product (GDP) when computing the average.

Competition Versus Trade

A common argument that is made for lowering corporate tax rates or moving to a territorial tax system is that doing so will allow the United States to remain competitive in the global economy. It is important, however, to distinguish between competition and trade. American companies compete against each other and foreign counterparts for customers, market share, investors, and the like. If one company does better, it is at the expense of the others in the industry. Thus, competition implies a contest, with winners and losers. In contrast, countries do not compete

¹¹ For information on comparing corporate tax rates across countries, see CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by (name redacted).

¹² Technically, the “marginal effective tax rate” is the appropriate measure to look at. The marginal rate is the effective tax on a prospective investment. For more information see, CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by (name redacted).

against each other, they trade with each other. When countries specialize in what they have a comparative advantage at producing and trade for what they have a comparative disadvantage at producing they are able to produce more together than in isolation. Greater production leads to more product variety, lower consumer prices, and greater average incomes.¹³

Although economists generally believe that trade leads to greater overall income, it is also recognized that particular groups may be hurt in the short term as the economy shifts its specialization focus. There are a range of policy options available to Congress to assist those displaced by trade including subsidies to assist affected industries, unemployment insurance, and retraining programs, among others. The relevant issue when contemplating potential policy options is how to effectively target assistance to those hurt by trade while not preventing the recognition of the widespread benefits of trade.

Summary and Related Readings

This report has provided an introduction to the U.S. international tax system. Understanding this basic foundation should help policy makers better understand and begin to evaluate many of the nuanced international tax issues. Going forward, questions to consider may include the following: Does the system need to be reformed in order for U.S. corporations to remain competitive? How far can the United States lower rates without negatively impacting the deficit? Are there any unintended consequences policy makers should be aware of when debating corporate tax reform?

Lastly, below is a list of other resources on the U.S. international tax system:

- CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by (name redacted)
- CRS Report R42927, *An Analysis of Where American Companies Report Profits: Indications of Profit Shifting*, by (name redacted)
- CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by (name redacted)
- CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by (name redacted)
- CRS Report R40178, *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis*, by (name redacted) and (name redacted)
- CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by (name redacted)
- CRS Report R43060, *Tax Reform in the 113th Congress: An Overview of Proposals*, by (name redacted)
- CRS Report R42726, *The Corporate Income Tax System: Overview and Options for Reform*, by (name redacted) and (name redacted)

¹³ British economist David Ricardo first formalized the idea of comparative advantage in his 1817 book titled *On the Principles of Political Economy and Taxation*.

- U.S. Congress, Joint Committee on Taxation, *Background And Selected Issues Related To The U.S. International Tax System And Systems That Exempt Foreign Business Income*, 112th Cong., 1st sess., May 20, 2011, JCX-33-11
- U.S. Congress, Joint Committee on Taxation, *Present Law And Background Related To Proposals To Reform The Taxation Of Multinational Enterprises*, 113th Cong., 2nd sess., July 21, 2014, JCX-90-14
- U.S. Congress, Congressional Budget Office, *Corporate Income Tax Rates: International Comparisons*, November 2005, <http://www.cbo.gov/sites/default/files/11-28-corporatetax.pdf>
- U.S. Government Accountability Office, *U.S. Multinational Corporations: Effective Tax Rates Are Correlated With Where Income Is Reported*, GAO-08-950, August 2008, <http://www.gao.gov/new.items/d08950.pdf>
- *OECD Tax Database*, <http://www.oecd.org/tax/tax-policy/tax-database.htm>
- *OECD Base Erosion and Profit Shifting*, <http://www.oecd.org/ctp/beps.htm>

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