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U.S. Taxation of Overseas Investment & Income: Background and Issues in 2002

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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 2000, the stock of private U.S. investment abroad was a full 26.4% 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 is a prominent issue before policymakers in Congress and elsewhere. First, because investment abroad is an increasingly important part of the economy, more pressure is placed on the U.S. system of taxing that aspect 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 the mobility of capital may call for a change in how U.S. taxes apply.

As it currently exists, U.S. tax policy towards investment abroad poses a patchwork of incentives, disincentives, and neutrality. Different features of the system, in isolation, have different effects. The foreign tax credit, for example, 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 indefinitely; it poses an incentive to invest overseas in countries that impose low tax rates of their own. Deferral is restricted, however, by the tax code's subpart F provisions which nudge the system back in the direction of tax neutrality.

Whether these various tax 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 – a policy termed "capital export neutrality" – best promotes world economic welfare. Economic theory also indicates, however, that U.S. economic welfare is maximized by a policy ("national neutrality") where overseas investment is, to some extent, discouraged. Yet a third policy standard – sometimes termed "capital import neutrality" – 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. A complete tax exemption for overseas income – a "territorial" system of taxation – would be consistent with capital import neutrality. Clearly, the different components of the U.S. system are consistent with different ones of the three policies; which one the current U.S. system best approximates, on the average, is not clear.

Should U.S. tax policy towards investment abroad be changed? It might be argued that the increased level of foreign investment makes any flaws that might exist in the U.S. system more serious. Yet given the various policy standards that have been recommended for U.S. taxation and given the varied impact of the current system, it is not surprising that proposals for change have varied.

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

Contents

List of Tables

U.S. Taxation of Overseas Investment and Income: Background and Issues in 2002

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 looks at how the U.S. tax system applies to that investment, and the policy issues it presents to Congress in 2002. It begins with a brief look at the data; it next describes the basic statutory features of the tax system and their effects on economic incentives. Next, it outlines the traditional economic framework for evaluating the system's economic effects. It concludes by describing policy proposals prescribed by the different perspectives on taxing international investment.

The United States in the World Economy

Even the most basic data clearly show that the U.S. economy is increasingly a part of the world economy. 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 25 years. In 1976, exports plus imports were 16.8% of gross domestic product (GDP); by 2000 trade was a full 25.4% of GDP.[1]

But the focus here is on capital investment, and if trade has increased substantially, investment has grown dramatically. In 1976, the stock of U.S. private assets abroad was 8.2% of the total U.S. private capital stock; by year end 2000, assets abroad were 26.4% of the total U.S. capital stock In 1976, the stock of foreign private assets in the United States was 4.2% of the U.S. capital stock; at year-end 2000 it was 31.5% of the U.S. capital stock.[2]

We now take a closer look at the components of outbound investment. Traditionally, economists have identified two types of overseas investment: portfolio 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

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[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 2002), p. 442.

[2]The source for data on U.S. assets abroad and foreign assets in the United States is Russell B. Scholl, "The International Investment Position of the United States at Yearend 2000," *Survey of Current Business*, vol. 80, July 2001, p. 7-15. Data on the U.S. capital stock are from Shelby W. Herman, "Fixed Assets and Consumer Durable Goods for 1925-2000," *Survey of Current Business*, vol. 80, Sept. 2001, pp. 27-38.

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 was 3.2% of the total U.S. capital stock; at the end of 2000, it was 20.0% of the total stock. In contrast, foreign direct investment was 5.0% of the total in 1976 and 6.4% at the end of 2000.

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 2000, they were 3.6% 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 1.9% of GDP; receipts from foreign direct investment grew from 1.0% of GDP to 1.5% 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 1999 they had grown to 15.3%.[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 now at the tax system that applies to the investment and its various incentive effects.

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

A good place to begin an overview of the U.S. international tax system is a look at broad jurisdictional principle. The United States generally bases its tax jurisdiction on an individual's or firm's residence, and much of the structure of U.S. international taxation follows from this principle. For example, the United States asserts the right to tax its residents and citizens on their worldwide income, regardless of where the income is earned. If, for example, a U.S. citizen lives in Germany and earns income in Germany, the United States, at least in principle, asserts the right to tax that income. In a parallel way, the United States also asserts the right to tax corporations chartered in the United States (i.e., its resident

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[3]Data on receipts from foreign investment are from Douglas B. Weinberg, "U.S. International Transactions, Third Quarter 2001," *Survey of Current Business*, vol. 81, Jan. 2002, pp. 29-57. U.S. capital income data are from *Economic Report of the President*, p. 306.

corporations) on their worldwide income. Thus, if a corporation chartered in, say, Delaware, earns income directly through a branch in Britain, the United States — again, in principle — asserts the right to tax that income.

But this just a general principle; actual U.S. practice departs from it frequently. One important departure, as we shall see, is the foreign tax credit, under whose provisions the United States permits its residents and corporations to credit foreign income taxes they pay against the U.S. taxes they would otherwise owe on foreign-source income. Although the United States asserts the right to tax income earned abroad, its foreign tax credit concedes that the country of source – that is, the country where the income is earned – has the primary jurisdiction to tax and is first in line to tax the foreign income. Another important exception to U.S. worldwide taxation is the "deferral principle," under which U.S. firms can indefinitely postpone income from foreign operations if they are structured in a particular way – that is, if the income is earned by a foreign chartered subsidiary corporation.

But U.S. international taxation is exceedingly complex; even its exceptions have exceptions, as we see by next turning to a more detailed look at the system.

Deferral

The deferral principle, or simply "deferral," is one of the chief features of the tax code for U.S. firms with foreign operations. As noted above, it allows U.S. firms that structure their foreign operations with subsidiaries rather than branches to indefinitely postpone U.S. taxes on their foreign-source income. Deferral's economic substance is thus a departure from the general principle of worldwide taxation on the basis of residence.

Deferral's place in the tax system actually results, however, from a literal, legalistic application of the residence principle, as follows: under the residence principle, a U.S.-chartered corporation is taxed on its worldwide income. In contrast, a corporation chartered abroad is taxed only by the United States on its U.S.-source income, and is exempt from U.S. tax on its foreign-source income.[4] But in substance if not legal form, firms can transcend mere corporate boundaries; for example, a U.S. firm can conduct its foreign operations through a subsidiary corporation chartered abroad. If it does so, the income the foreign corporation earns is exempt from U.S. taxation as long as it remains in the subsidiary's hands; the subsidiary's income is generally subject to U.S. tax only when it is remitted to the U.S. parent corporation as intra-firm dividends, interest payments, royalties, or other income.

For a firm, taxes matter less the longer payment can be postponed; this is the heart of deferral. In essence, a dollar of taxes paid today is more costly than a dollar paid next year because the firm can invest next year's dollar over the interim period and earn a return. Thus, as a general matter, the tax burden on investment abroad is lower than on identical investment in the United States in any case where the tax rate imposed by the foreign host government is lower than the U.S. tax rate on identical

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[4]It is, however, generally taxed by the United States on its U.S.-source income.

investment. As a consequence deferral poses an incentive for U.S. firms to invest abroad in low-tax countries.

But as noted above, the tax code has exceptions to exceptions. In the case of deferral, the Subpart F provisions and several other anti-deferral regimes restrict deferral, especially in the case of portfolio investment. Nonetheless, deferral is still potentially available to most manufacturing operations abroad in low-tax foreign countries. We turn next to the exceptions to deferral.

Subpart F and Other Exceptions to 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.[5] 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 only applies 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.

The second most significant exception to deferral is the Passive Foreign Investment Company (PFIC) provisions, which were enacted by the Tax Reform Act of 1986. If, roughly speaking, Subpart F applies only to large (10%) U.S. shareholders, and only to certain types of income earned through CFCs, the PFIC rules deny deferral to all U.S. shareholders on all income earned by any foreign corporation, controlled or not, that is intensively engaged in passive investment, as measured by the PFIC rules.

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[5]For a discussion of the circumstances of Subpart F's enactment, see CRS Report 95-1143, *Anti-Tax Deferral Measures in the United States and Other Countries*, by Harry G. Gourevitch.

More specifically, the PFIC rules deny deferral to U.S. stockholders of a foreign corporation that the tax code classifies as a PFIC. A foreign corporation is classified as a PFIC if 75% or more of its gross income is income from passive investment, or if 50% or more of its assets are passive investments. The deferral benefit is generally denied by requiring PFIC shareholders to include their share of the PFIC's income in their own taxable income whether it is distributed or not, or, alternatively, by requiring payment of interest on the deferred tax liability.

The Foreign Tax Credit

The U.S. foreign tax credit is a central feature of the system for both individuals and firms. Its provisions generally permit U.S. taxpayers, both corporations and individuals alike, to credit foreign income taxes they pay against U.S. income taxes they would otherwise owe. The credit's function in the system is to alleviate double-taxation where the U.S. residence-based tax jurisdiction overlaps with a foreign host-country's source-based jurisdiction. Double-taxation could potentially result in prohibitively high tax rates on foreign investment and could pose a severe impediment to international capital flows. As noted above, by shouldering the responsibility for alleviating double-taxation the United States effectively concedes that the country of source has the primary jurisdiction to tax that income.

The tax code places a limit on the foreign tax credit that is designed to protect the U.S. tax base, and the United States' own primary jurisdiction to tax U.S.-source income. The limitation works by effectively placing a barrier between U.S.-source income and foreign-source income; if an investor's foreign taxes on foreign-source income exceed U.S. taxes on the income, they cannot be credited and become so-called "excess credits." If not for the limitation, foreign governments could conceivably impose extremely high tax rates on the U.S. investors they host. With an unlimited credit, investors would be impervious to the high foreign tax rates; they could simply credit their foreign taxes against U.S. taxes. At the same time, while the foreign government would be collecting plentiful revenues it would not be damaging its own attractiveness as an investment location.

The foreign tax credit and its associated rules account for some of the most complex sections of the Internal Revenue Code, much of them stemming from the credit's limitation. And unlike the deferral principle, whose incentive effect is straightforward, the foreign tax credit's effects vary. We turn now to these incentive effects.

The Foreign Tax Credit and the Tax Rate on Foreign Income

Basic arithmetic and the foreign tax credit limitation dictate that total taxes paid by a U.S. investor may consist of both U.S. and foreign taxes, but they are paid at a combined rate equal to either the average foreign tax rate or the U.S. tax rate, whichever is higher. For example, suppose a person has foreign income exclusively from a country with low tax rates compared to the United States. He could credit all of his foreign taxes against his U.S. tax liability without exhausting his U.S. tax liability on foreign income and reaching the credit's limitation. He would pay foreign taxes at the foreign rate, and after applying credits he would pay U.S. taxes at the U.S. rate minus the foreign rate. Total taxes on foreign income would thus be paid at the U.S. rate, but would consist of both foreign and U.S. taxes.[6]

Suppose a person pays foreign taxes at an average rate greater than the U.S. rate. He would have sufficient foreign tax credits to eliminate his entire U.S. tax liability on foreign source income. But because of the limitation, he would not be able to credit the excess of his foreign taxes over the U.S. foreign-source liability; to do so would require crediting foreign taxes against U.S. taxes on U.S. income. Thus, his taxes on foreign income would consist exclusively of foreign taxes; they would be paid, of course, at the foreign tax rate.

The Foreign Tax Credit and Incentives to Invest or Work Abroad

The tax credit limitation and the tax rates it produces create a particular incentive structure for investing or working abroad. As we noted above, a person pays total taxes on foreign income at either the U.S. tax rate or the foreign tax rate, whichever is higher. It follows that if a person has no other foreign income and thus has no excess foreign tax credits to complicate matters, the foreign tax credit limitation is "neutral" towards (has no effect on) the incentive to invest or work in a country with low taxes, since taxes are the same as in the United States. On the other hand, the limitation permits a disincentive to exist with respect to investing or working in a high-tax country; taxes on the prospective foreign activity stand to be higher than on the same activity in the United States.

But this assumes that the U.S. person or firm has no other existing foreign income; if there is other foreign income, the foreign tax credit situation with respect to the income can change the incentives. First, suppose the existing foreign income is taxed at such a high foreign rate that the taxpayer has excess foreign tax credits that cannot be used because of the limitation. In such a case, while there is still a disincentive towards high-tax countries, there is an incentive to invest or work in a low tax country. This is why: a person with excess credits can generally use them to offset some or all of the new U.S. taxes that would otherwise be due on the new income earned in the low-tax country. In effect, the excess credits shield the new income from U.S. taxes. The new income investment or activity thus faces only the low foreign tax rate while an identical activity in the United States would face the relatively higher U.S. tax rate.

An investor's existing income can also alter the situation facing prospective activity that is subject to high foreign taxes. Suppose, for example, the existing income is subject to low foreign taxes so that the investor has a residual U.S. tax liability, after credits, that is equal (as we have seen) to the pre-credit U.S. rate minus the foreign rate. If the investor obtains new income subject to high foreign taxes, an

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[6]If we represent the U.S. tax rate as "u" and the foreign tax rate as "f", before credits the total tax rate on foreign income would be: $u + f$. After credits, the total rate would be the before credit rate minus credits, or: $(u + f) - f$, which is equal to u, the U.S. tax rate. As used here, "rate" is the average rate: total taxes as a percent of total taxable income.

amount equal to the U.S. tax rate on the new income must be devoted to offsetting the U.S. taxes on the new income itself. However, any additional foreign taxes on the new income can be used to reduce the residual U.S. taxes owned on existing income from low-tax foreign activities. Thus, the tax rate on the new, heavily taxed investment is reduced, in effect, to a rate equal to the U.S. tax rate. In short, the disincentive that would otherwise exist with respect to the high tax activity is converted to neutrality when an investor has existing income from a low tax country.

The following table shows the various incentives posed by the foreign tax credit schematically.

Incentives Towards Foreign Investment Facing Firms in Different Foreign Tax Credit Situations

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)

The rows show incentives faced by firms in various foreign tax credit positions: those with no previous, existing foreign investment (and thus with neither an existing U.S. tax liability on foreign income nor excess credits); those with excess credits; and those with a "deficit" of credits (a residual U.S. tax liability on existing overseas investment). The columns show incentives with respect to investment in countries with tax rates of their own that are higher than the United States ("high-tax" countries) and countries with relatively low tax rates ("low-tax" foreign countries).

Income with Separate Limitations or "Baskets"

The particular incentive structure we have described applies in cases where investors are free to credit taxes paid on one stream of income against U.S. taxes owed on another stream of foreign income that is taxed at a different foreign rate. In 1986, the Tax Reform Act sought to reduce (but not eliminate) instances where this effect could occur by requiring that the foreign tax credit limitation be applied separately for several different types of income. In tax parlance, the 1986 Act created a number of different foreign tax credit "baskets" into which different types of income were required to be placed. 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. A partial list of the specific separate baskets includes: income from passive investment; income subject to high foreign withholding taxes;[7] financial services income; and shipping income.

Source of Income Rules

The foreign tax credit limitation 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 items of gross income. For example, suppose a U.S. investor with extensive foreign investments sells stock in a U.S. company, but in a foreign stock market. Is the profit from the sale U.S. source income or foreign source income? If a taxpayer is above the foreign tax credit limitation — that is, if they pay foreign taxes at a high rate so that they have excess credits — and the profit is classified as foreign-source income, the investor will owe no U.S. taxes on the gain; if it has a U.S. source, the investor will.[8] The tax code's rules governing the source of income and the associated Treasury regulations are numerous, complex and varied; they are not summarized here. It is important to note, however, that much of the legislative activity in the international area is devoted to adjusting the source rules. In general, a change in law that shifts the source of an item's income abroad reduces taxes; a change that shifts an item of income to U.S. sources increases them. Conversely, legislation that shifts an item of deduction from U.S. to foreign sources raises taxes, while shifting it to U.S. sources reduces them.

Domestic Investment Incentives

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, 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

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[7]A "withholding tax," as used in this context, is a tax a country that is host to an investment by a non-resident generally applies to the interest, dividends, royalties, and similar income generated by the investment. The tax is generally levied at a flat rate, is applied on a gross basis (i.e., without allowing for deductions), and is required to be withheld by the payer.

[8]In general, section 865 of the Internal Revenue Code allocates ("sources") income from the sale of personal property (e.g., stock) in an investor's country of residence. In this example, then, the income would have a U.S. source and — in principle — would be subject to U.S. tax.

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."

Other incentives for domestic investment are export tax benefits. There are two of these: the "inventory source" rule, and the extraterritorial income (ETI) exemption that replaced prior law's Foreign Sales Corporation (FSC) provisions. In these cases, exports, by definition, can only be produced by domestic investment, and so an export tax benefit is necessarily an incentive for domestic rather than foreign investment. Indeed, the FSC provisions' statutory predecessor, the Domestic International Sales Corporation (DISC) provisions, were in part enacted in order to provide a tax incentive for domestic investment that would counter deferral.[9]

Thus far we have confined our economic analysis to identifying the international system's various incentive effects. We look next at the broader economic consequences of these incentives and the different policy perspectives on those effects.

Policy Perspectives

According to economic theory, the various incentive effects that the tax system has on investment flows can affect both the U.S. and world economies by changing the allocation of capital resources between the United States and abroad. Various effects flow from that allocation of investment, including impacts on both capital and labor income, on tax revenue, and ultimately on the economic welfare of the United States and the world at large.

One broad effect of the capital flows to and from the United States is the distribution of income within the United States and abroad. Thus, taxes on foreign investment affect the distribution of income. Capital flows affect the distribution of

[9] In response to complaints by the European Union, World Trade Organization (WTO) panels have ruled that both FSC and the ETI provisions are export subsidies and so violate the agreements on which the WTO is based. For further information, see CRS Report RS21143, *Policy Options for U.S. Export Taxation*, by David L. Brumbaugh.

income as follows: a basic principle of economic theory holds that in smoothly operating markets, labor compensation is commensurate with its productivity. 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; firms tend to support them.

Taxes on capital flows also have broad effects on economic efficiency, or the level of economic benefit produced by capital and other resources. Economic theory has developed two standards for evaluating the efficiency of international taxation, each with a different perspective: "capital export neutrality," which considers the impact of taxes on world economic welfare; and "national neutrality," 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." Having described the U.S. tax system and its incentive effects, we now look at how the system measures up to these different standards and identify the particular issues each standard presents.

Capital Export Neutrality: Maximizing World Economic Welfare

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 is least distorting of investors' decisions and of how capital is employed. CXN is a policy that is "neutral" towards the decision whether to invest at home or abroad – a policy where taxes do not affect or distort an investor's decision of where to invest and the world's capital resources are employed where they are most productive. The world's economic welfare is therefore maximized. In short, under CXN, the world's economy is getting the most from its capital resources.

The U.S. system is consistent with capital export neutrality in some cases, but not others – an outcome that is not surprising, given the varied incentive effects reviewed in the preceding section. It is clear, for example, that the United States' deferral principle violates capital export neutrality with respect to investment in countries with low tax rates – deferral distorts investment by favoring investment in low-tax countries and by diverting investment from the United States to those locations. Subpart F and the other anti-deferral regimes nudge the system incrementally back in the direction of CXN.

If the foreign tax credit had no limitation, it would establish CXN in cases where deferral is not a factor. As we have seen, however, the limitation results in varied effects, but the limitation moves the system away from capital export neutrality by (on the average) discouraging foreign investment. The ability of investors to cross-credit foreign taxes paid to high-tax countries mitigates the limitation's disincentive effects; at the same time, however, cross crediting distorts the allocation of U.S. investment among foreign countries, favoring investment in countries with low tax rates over high-tax countries.

National Neutrality: Maximizing U.S. Economic Welfare

The tax policy that maximizes world economic welfare is not necessarily that which maximizes U.S. economic welfare. CXN, in other words, is not necessarily optimal from the narrow perspective of the United States. 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.

The current United States tax system contains elements that are consistent with the NN standard. In cases where the foreign tax credit's limitation poses a disincentive to investment abroad, the optimal tax rate on foreign investment may be approached or even surpassed. But in cases where the foreign tax credit establishes neutrality or provides an incentive towards overseas investment, U.S. economic welfare is not maximized. The deferral principle, in other words, along with the foreign tax credit, are inconsistent with national neutrality. The position of the system, on the average, is ambiguous.

Competitiveness as a Standard

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)." 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.[10] 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 research.[11] 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 applied 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

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[10]Daniel J. Frisch, "The Economics of International Tax Policy: Some Old and New Approaches," *Tax Notes*, April 30, 1990, pp. 590-1.

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

would be increased by cutting taxes on overseas investment as in CMN.[12] 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?[13]

We next examine several prominent policy proposals for U.S. international taxation, and show how each relates to CXN, NN, and CMN.

Current and Recent Proposals

Proposals Supporting Capital Export Neutrality

A system of pure CXN would be established by a policy of worldwide taxation of residents, (implying repeal of deferral) and an unlimited foreign tax credit. However, few proposals have been made in recent years that are designed to establish broad CXN by the U.S. system. Proposals to restrict deferral tend to gather momentum during periods of domestic recession or high unemployment; as we have seen, deferral tends to reduce domestic labor earnings by encouraging capital to move abroad. Given the unprecedented length of the recent U.S. economic expansion, the lack of numerous recent proposals to repeal deferral is not surprising.

A prominent past proposal to repeal deferral was the Burke-Hartke measure that was introduced in Congress in 1971 and again in 1973. The bill was strongly supported by organized labor, and a primary concern of its supporters was the perception that deferral led to the "export" of U.S. jobs. Another prominent proposal for deferral's repeal was made in 1978 by the Carter Administration. But neither Burke-Hartke nor the Carter proposal were adopted. Further, even the Tax Reform Act of 1986, with its sweeping changes to promote efficiency and tax neutrality generally confined its international tax changes to an incremental expansion of Subpart F and refinements in the foreign tax credit limitation and related source-of-income rules.

More recently in December, 2000, the United States Treasury Department issued a report on taxation of U.S. controlled foreign corporations and subpart F. The report concluded that if the goal of tax policy is to maximize global economic welfare, the CXN is the best policy.[14] Further, the report stated that ending the deferral principle would be the specific policy that would have the "most positive long-term effect on

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[12]Thomas Horst, "A Note on the Optimal Taxation of International Investment Income," *Quarterly Journal of Economics*, vol. 94, June 1980, pp. 793-5.

[13]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.

[14]U.S. Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations* (Washington: 2000), p. 97.

economic efficiency and welfare."[15] Yet even with these conclusions, the report made no specific policy recommendations.

Recent congressional proposals supportive of CXN have tended to be incremental in nature. For example, H.R. 4133 in the 106th Congress (proposed by Representative Evans) would have repealed deferral for income from oil extraction. Also, bills that would repeal deferral for "runaway plants" have been proposed at various times in the past. (See, for example, S. 1597 and H.R. 3252 in the 104th Congress, proposed by Senator Dorgan and Representative McKinney.) The proposals attempted to identify firms that shut down domestic production, open factories abroad, and export goods back to the United States; the firms' income would be taxed on a current basis.

One of the most prominent of recent congressional proposals that would move the U.S. system in the direction of CXN actually would reduce rather than increase multinationals' taxes by reforming source rules related to the foreign tax credit limitation. (The limitation, as we have seen, inhibits CXN by allowing a disincentive to exist in high-tax countries.) The proposal was aimed at rules governing the allocation of interest expense between foreign and domestic sources. In broad terms, current law's rules work like this: if a U.S. firm has foreign investments, at least part of its U.S. interest expense must be allocated to foreign rather than domestic sources based on the theory that debt is fungible – that regardless of where funds are borrowed, they support a firm's worldwide domestic investment. For firms that have excess foreign tax credits and for whom the foreign tax credit limitation is a binding constraint, allocation of interest expense abroad has the effect of reducing creditable foreign taxes – in effect, such firms lose the benefit of the interest deduction for any interest allocated abroad.

In contrast to these "sourcing" rules for U.S. interest, current law does not permit any part of the interest expense of foreign subsidiaries to be allocated to U.S. sources. The Taxpayer Refund and Relief Act of 1999 would have permitted firms to use a part of a foreign subsidiary's interest expense to reduce U.S. rather than foreign income, thus increasing creditable foreign taxes while reducing U.S. tax. The change would have mitigated the disincentive posed by the foreign tax credit limitation and would have nudged the system incrementally in the direction of CXN. The Act was vetoed, however, by President Clinton for reasons not directly related to its interest allocation provisions.[16]

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[15] *Ibid.*, p. 90.

[16] For background and analysis of the provision, see CRS Report RL30321, *The Taxpayer Refund and Relief Act of 1999 and the Foreign Tax Credit's Interest Allocation Rules*, by David L. Brumbaugh and Jane G. Gravelle.

Territorial Taxation and Proposals Supporting Capital Import Neutrality

If CXN would be accomplished by worldwide taxation on the basis of residence and an unlimited foreign tax credit, CMN would be accomplished by exempting foreign-source income altogether. Such a regime would, in effect, be a "territorial" tax policy rather one based on "residence." Under a territorial system, the capital exporting country (in this context the United States) looks to the source of income in determining its tax jurisdiction rather than the residence of the taxpayer. Among major U.S. trading partners, France and the Netherlands have territorial systems.

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.[17] A prominent recent proposal for general adoption of a territorial tax system was that made by the National Commission on Economic Growth and Tax Reform (the "Kemp" commission on fundamental tax reform).[18]

Support of a CMN that would be more limited in scope has been based on analyses that distinguish between portfolio investment and direct investment, recommending CXN for the former and CMN for the latter. As noted above, for example, some have argued that growth in international flows of portfolio investment means that while portfolio investment plays an important role in the efficient allocation of world capital, direct investment no longer does and performs alternative economic functions. According to this view, while CXN is efficient for portfolio investment, tax policy towards foreign direct investment should avoid placing multinationals at a competitive disadvantage with respect to foreign firms.[19] Again, however, it can be pointed out that if multinationals conduct activities deserving subsidization, those activities, such as research, might be more accurately targeted than with a policy of exempting foreign investment income altogether. The Treasury

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[17]See the statement submitted to the Senate Finance Committee by Fred F. Murray on behalf of the National Foreign Trade Council, in U.S. Congress, Senate Committee on Foreign Relations, *International Tax Issues Relating to Globalization*, hearing, 106th Cong., 1st sess., March 11, 1999 (Washington: GPO, 1999), p. 113.

[18]Notwithstanding support of CMN on the basis of competitiveness for U.S. firms, CMN would reduce overseas investment if, on the average, foreign tax rates are relatively higher than U.S. taxes on domestic investment (as noted above). In addition to a territorial tax system, the Kemp commission recommended a complete tax exemption for all saving and investment – domestic as well as foreign. CMN would exist under a system that exempts capital income but would necessarily reduce the flow of investment abroad to countries that still tax capital (assuming the U.S. capital stock is fixed). As a matter of terminology, note also that such a system's international tax system would not, strictly speaking, be "territorial," since the United States would not exercise jurisdiction to tax investment income on any basis.

[19]Daniel J. Frisch, "The Economics of International Tax Policy," p. 590.

Department's recent report, however, cites subsequent studies that question Frisch's conclusions on several grounds: for example, that capital is limited in its mobility.[20]

Recent legislation supporting CMN that has been actively considered by Congress has been incremental in nature. For example, the Job Creation and Worker Assistance Act (P.L. 107-47) that Congress passed in March 2002, extended for 5 years (through 2006) a temporary exclusion from Subpart F of portfolio-type income derived from the active conduct of a banking, finance, or insurance business.

The topic of "territorial" taxation also surfaced in legislation that Congress adopted late in 2000 to replace the Foreign Sales Corporation (FSC) tax benefit for exporting. In response to a complaint by the European Union, the World Trade Organization (WTO) ruled in 1999 that the FSC provisions were an export subsidy and were thus prohibited by the WTO agreements. H.R. 4986 in the 106th Congress, the replacement legislation enacted in 2000 (P.L. 106-519), was designed to bring the export benefit into WTO-compliance by adopting certain aspects of a territorial tax system, which had been adjudged to be permissible under international agreements. P.L. 106-519 grants a partial U.S. tax exemption to a limited amount of a U.S. exporter's foreign-source ("extraterritorial," under the law) income along with part of its export income.[21] In isolation, the foreign investment parts of the law thus support CMN. At the same time, however, export incentives such as those in the other parts of the law promote investment in the United States rather than abroad.

Proposals Supporting National Neutrality

Specific proposals consistent with national neutrality have tended to be incremental in nature – perhaps even more so than with CXN or CMN proposals. They have also been relatively rare, even in the past. In some cases "runaway plant" proposals would not only restrict deferral but would impose a surtax on overseas subsidiaries that export back to the United States. H.R. 4133 in the 106th Congress, along with its repeal of deferral, would have restricted in certain ways the creditability of foreign taxes on oil income. But even in this case, it could be argued that the oil taxes that H.R. 4133 has restricted are actually in many cases royalty payments to foreign governments who own the extracted oil, not taxes.

H.R. 5095, 107th Congress

A prominent proposal in the international tax area is H.R. 5095, introduced on July 11, 2002, by Chairman Thomas of the House Ways and Means Committee. The bill pulls together a number of broad policy themes in international taxation. In broad terms, the proposal would 1) repeal the extraterritorial income (ETI) tax benefit for exporters, thus seeking to end the long-running dispute between the U.S. and the European Union (EU) over U.S. export benefits; 2) provide tax cuts and tax

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[20] U.S. Treasury Department, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, p. 35.

[21] CRS Report RS20746, *Export Tax Benefits and the WTO: Foreign Sales Corporations (FSCs) and the Extraterritorial (ET) Replacement Provisions*, by David L. Brumbaugh.

simplification for the overseas operations and income of U.S. firms; and 3) adopt temporary tax measures aimed at corporate "inversions" or "expatriation" along with permanent, tighter rules designed to inhibit "earnings stripping," where foreign parent companies shift U.S.-source income out of the U.S. tax jurisdiction.

Strictly speaking, **the ETI tax benefit for exporting** does not affect overseas investment, the topic of this report; exports, by definition, involve production in the exporting country. Nonetheless, the ETI/EU imbroglio has been a prominent recent issue in U.S. international taxation and so deserves mention. Under the U.S. residence-based international tax system, the United States would ordinarily tax income its resident businesses earn from sales of U.S.-made goods abroad. However, prior to 2001, the U.S. tax code's Foreign Sales Corporation (FSC) rules provided an explicit tax benefit for exporting.[22] The FSC provisions were the statutory descendant of an earlier tax benefit – the Domestic International Sales Corporation (DISC) provisions, first enacted in 1971. However, European countries charged that DISC was an export subsidy and so violated the General Agreement on Tariffs and Trade (GATT). Although a GATT panel supported the European charge, the United States never conceded that DISC violated GATT. The FSC provisions were enacted in 1984 in an attempt to defuse the controversy.

In 1997, the countries of the European Union complained to the World Trade Organization (successor to GATT) that FSC also was an export subsidy and contravened the WTO. A WTO panel ruling upheld the EU complaint, and to avoid WTO-sanctioned retaliatory tariffs, the United States in November 2000 replaced FSC with the ETI provisions, which deliver a tax benefit of similar size but that was redesigned in an attempt to achieve WTO compliance. The United States maintained that the ETI provisions were WTO-compliant, but the EU disagreed and asked the WTO to rule against them and approve $4 billion in tariffs. A WTO panel ruled against the ETI provisions in August 2001, and in January 2002, a WTO appellate body denied an appeal by the United States. A WTO arbitration panel subsequently began consideration of the EU's request for tariffs; observers have suggested a ruling will be issued during the summer of 2002.

Some EU officials have suggested that the EU is not eager to impose sanctions and will delay their implementation as long as it believes the United States is making progress in becoming WTO-compliant. Unlike the previous legislative responses to GATT and WTO rulings, H.R. 5095 does not attempt to construct a WTO-compliant export tax benefit. Rather, it simply repeals the provision.

In addition to its ETI repeal, H.R. 5095 containd a wide range of provisions affecting the **overseas operations of U.S. firms**, but here the bill's changes would generally provide tax reductions. The proposals fall in two broad areas: those affecting **the foreign tax credit and related provisions; and those affecting the**

[22]An alternative, implicit tax benefit for exporting is provided by the so-called "export source rule," under whose terms an exporter can allocate as much as 50% of export income to foreign sources for purposes of calculating its foreign tax credit limitation. This has the effect of providing a 50% tax exemption for firms in an excess credit position. The EU has not lodged a complaint against the export source rules.

deferral principle and subpart F. The most important foreign tax credit proposal is likely the bill's modification of the rules for allocating interest expense for purposes of determining firms' foreign tax credit limitation. As described above (see page 14), a reform of current law's interest expense rules was proposed in 1999 but was part of a bill that was vetoed. H.R. 5095's changes would implement the same changes, generally provided more generous treatment of interest expense by taking into account the borrowing of foreign subsidiary corporations.

Other foreign tax credit provisions of H.R. 5095 would consolidate the number of separate foreign tax credit "baskets" (see section above on *Income with Separate Limitations or "Baskets"*) to three from current law's nine; allow dividends from certain foreign corporations to receive "lookthrough"[23] treatment and to be placed in baskets reflecting the character of the earnings out of which they were paid; permit domestic losses in one year to be recharacterized as foreign-source income in future years; extend the foreign tax credit carryforward period to 10 years from current law's 5; and repeal current law's 90% restriction on the portion of minimum tax liability that can be offset by foreign tax credits.

The most prominent of the bill's changes to deferral and subpart F is repeal of subpart F's foreign base company sales and service income rules. In general, these rules place income from sales of goods (or provision of services) to related firms within the scope of subpart F, taxing such income of controlled foreign corporations on a current basis. The bill's repeal of the rule thus expands the deferral principle to include such income. Other deferral and subpart F proposals in the bill include expanding the lookthrough rules for dividends received by subsidiaries from related corporations; removal from subpart F of gain from the sale of partnerships; and repeal of several narrow regimes (other than subpart F) that restrict deferral.

A number of proposals have been made in the current Congress that are intended to quash transactions termed **corporate "inversions" or "expatriations**." In general, these are reorganizations undertaken by corporate groups, under which the "parent" corporation or holding company is switched from a corporation chartered in the United States to a newly created parent corporation chartered abroad in a low-tax country or tax haven. In recent months, the number of inversions undertaken for tax reasons appears to have increased; since foreign corporations are not immediately subject to U.S. tax on their foreign-source income, an inverting transaction can save substantial taxes for a U.S. firm with extensive foreign operations. A number of bills in Congress would attempt to restrict inversions by taxing inverted foreign parent corporations in the same manner as domestically-chartered firms. H.R. 5095 would do so, but on a temporary basis, applying its restrictions for 3 years.

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[23]In general tax parlance, "lookthrough" rules denote situations where taxpayers are permitted or required to look beyond the immediate character of an item of income (in determining how to characterize it for tax purposes) to its nature in the hands of the payor corporation or entity. Thus, for example, a dividend that receives lookthrough treatment for foreign tax credit purposes might be classified as active, general business income rather than passive income.

U.S. firms that invert can apparently also reduce their U.S. taxes by engaging in a practice known as "earnings stripping," by which U.S.-source income can be shifted from a U.S. subsidiary corporation to a foreign parent corporation beyond the U.S. tax jurisdiction. Intra-firm debt is one commonly used earnings stripping device: a foreign parent might lend funds to its U.S. subsidiary and charge its subsidiary interest. The interest payments are tax-deductible and – if the loan is structured in certain ways – the U.S.-source interest received by the foreign parent is not subject to U.S. tax. Earnings stripping can be used by foreign firms in general, and is not restricted to inverted U.S. firms, and the U.S. tax code contains a number of provisions aimed at earnings stripping that restrict the deductibility of interest paid to related corporations. H.R. 5095 would expand the scope of the current rules. In contrast to the inversion provisions, the earnings stripping measures would not be temporary.

Given the varied nature of H.R. 5095's different provisions, it is difficult to identify its place in the CXN/CMN/NN structure. For example, the bill's inversion provisions may increase the tax burden on overseas investment by U.S. savers (i.e., stockholders) investing through inverted U.S. firms. In isolation, these provisions of the bill may nudge the system in the direction of CXN, albeit by a very small and temporary amount. In contrast, the bill's subpart F and deferral provisions probably move the system in the direction of CMN while its foreign tax credit provisions probably move the system in the direction of CXN at the expense of elements of the system that have effects consistent with NN.

Conclusions

The economic effects of various parts of the U.S. international tax system vary, and that the policy perspectives on the merits of those effects vary also. Deferral poses an incentive to invest abroad; the foreign tax credit limits a disincentive. To complicate matters further, the merits of deferral and the foreign tax credit limit differ, depending on whether one emphasizes world economic welfare and capital export neutrality or U.S. economic welfare and national neutrality.

This report documents the growing U.S. involvement in the world economy and growing stock of U.S. investment employed abroad. Because U.S. involvement in the world economy is growing, any flaws in the U.S. system are potentially becoming more important. And because each of the three policy perspectives of CXN, NN, and CMN adjudge the present system to be imperfect by their own standards, pressure to change the system is likely to increase. International taxation is thus likely to continue to be an important policy issue before Congress throughout 2002.