
Agenda for Modest Reform: A Territorial System

The road to sweeping tax reform is long and arduous, as beneficiaries of the existing system can be counted on to vigorously oppose change. Bearing the political reality in mind, in this chapter we propose moderate reforms confined to US taxation of foreign-source income. In fact, several of our international tax policy goals can be achieved without disturbing the current US system for taxing domestic business income. We recommend changes that would strengthen the United States as a base for multinational enterprises (MNEs). These changes would go a long way toward addressing the challenges of the global economy. However, the US corporate tax rate would not be altered, US rules governing the taxation of foreign MNEs doing business in the United States would be unchanged, and there would be no adjustment of federal taxes for traded goods and services at the US border.

Nearly all commentators agree that US taxation of foreign operations needs reform, but they disagree about the shape that a new system should take. Table 6.1 sketches competing plans and compares them with the existing system. Commentators agree on maintaining the existing system of taxation for international portfolio income—essentially passive income—and income from kindred mobile sources, such as royalties and fees.¹ Taxing these income flows on a current basis without deferral is needed to limit abuse by creative lawyers and their rich clients. Otherwise vast

1. The label of “mobile income” was adopted by the President’s Advisory Panel on Federal Tax Reform (2005) for portfolio interest and dividends, all royalties and fees, and leasing income. Rosenbloom (2001) was among the first advocates of this distinction.

Table 6.1 Comparative plans for international tax reform

Item	Post-AJCA US system^a	President's tax reform panel^b	Grubert and Altshuler: Worldwide taxation	Rosenbloom: Bottom-up taxation	Desai and Hines: Capital ownership neutrality
Income					
Active business profits earned abroad	Taxed at corporate rate once repatriated to the United States as dividends; indefinite deferral allowed	Exempted from US corporate tax	Taxed at corporate rate; no deferral allowed. However, extra revenue would be used to lower the average US corporate rate	Exemption of active business profits earned in a "normal" tax jurisdiction (no exemption for low-tax jurisdictions)	Exempted from US corporate tax
US export profits	Half of export profits can be characterized as foreign-source income and take advantage of the foreign tax credit	Not considered	All export profits characterized as US-source income	Taxed currently	Not considered
FDI interest and royalties, portfolio dividends and interest	Taxed at corporate rate; no deferral allowed; subpart F ensures current taxation of foreign holding companies	These receipts are termed "mobile income" and taxed at corporate rate; no deferral allowed	Taxed at corporate rate; no deferral allowed	Current taxation of passive income not constituting active business profits	"Truly passive income," a subset of subpart F income, taxed at US corporate rate; no deferral allowed

Expense allocation in general	US expenses are deductible from US corporate income, even when allocated to foreign-source income. However, expenses allocated to foreign income reduce the foreign tax credit limit	US deductions disallowed for expenses allocated to exempt foreign income	Expense allocation rules are largely unnecessary: Since all business income is taxed at the same rate, firms have less tax motivation to distort expense allocation for tax reasons	Expenses allocated to exempt income would not be deductible	Not considered
Interest expense	Corporations can elect to use “world-wide fungibility” interest allocation. Under this provision, worldwide interest expense is allocated based on foreign-to-domestic asset ratio of world-wide affiliated group. Otherwise US interest expense is apportioned on the basis of gross income from domestic and foreign sources	Determined by US debt-to-asset ratio versus world-wide group debt-to-asset ratio			

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Table 6.1 Comparative plans for international tax reform *(continued)*

Item	Post-AJCA US system^a	President's tax reform panel^b	Grubert and Altshuler: Worldwide taxation	Rosenbloom: Bottom- up taxation	Desai and Hines: Capital ownership neutrality
Administrative/ headquarters expense	Expenses directly related to a basket of gross income must be allocated to that basket. Expenses not directly related to any basket are apportioned on the basis of gross income in each basket	Divided between domestic income, exempt foreign income, and non-exempt foreign income. Expenses allocated to exempt foreign income may not be deducted. Expenses allocated to nonexempt foreign income may be deducted but also reduce the foreign tax credit (FTC) limit	All administrative and headquarter expense incurred in the United States is allocated to US income		
Research, development, and experimentation (RD&E) expenses	Expenses directly related to a basket of gross income must be allocated to that basket. Expenses	All RD&E expense may be deducted. For FTC purposes, expenses are allocated between	All RD&E expense incurred in the United States is allocated to US income		

	not directly related to any basket are apportioned on the basis of gross income in each basket	domestic and foreign income. Expenses allocated to foreign income reduce the FTC limit for "mobile income"			
Foreign tax credit	Allowed but limited by potential US tax liability for each basket of income	FTC allowed for foreign taxes on "mobile income." Active "foreign business income" does not carry credits since the income is exempt from US tax	Allowed, subject to FTC limit equal to overall US tax liability on the foreign income	Foreign taxes on exempt income would not be allowed as a credit, but a credit would be allowed for taxes on nonexempt income	Not considered
Income categories	Income divided into active income (dividends and royalties) and passive income. Income from all countries aggregate into one basket or the other for FTC limit purposes	Single, overall basket for "mobile income"	All income considered part of a single basket with a single FTC limit	Rules similar to those that govern transfer pricing would determine classification of income	Not considered

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Table 6.1 Comparative plans for international tax reform *(continued)*

Item	Post-AJCA US system^a	President's tax reform panel^b	Grubert and Altshuler: Worldwide taxation	Rosenbloom: Bottom- up taxation	Desai and Hines: Capital ownership neutrality
Carry-forward/ carry-back	Excess credits can be applied one year back, 10 years forward	Not considered	Not considered	Not considered	Not considered
Financial entities	Special rules permit financial service companies to defer financial income, even though this income would be currently taxed if earned by a non-financial company	Special rules allow financial institutions to exempt income "earned though active business operations abroad," even though this income would be currently taxed if earned by a nonfinancial company	Not considered	Not considered	Not considered
Corporate tax rate	35 percent	31.5 percent	28 percent	Not considered	Not considered

a. The American Jobs Creation Act (AJCA) will be fully phased in by 2009.

b. The tax advisory panel considers restructuring of the entire US tax system; we concentrate on the changes relevant to international business taxation.

Sources: AJCA, available at <http://thomas.loc.gov>; Grubert and Altshuler (2006); President's Advisory Panel on Federal Tax Reform (2005); Desai and Hines (2004); Rosenbloom (2001).

avenues would be opened for wealthy US taxpayers to avoid the individual income tax. If portfolio income flows could escape US taxation on a current basis, interest and dividends, fees paid to entertainers and sports figures, and even options for chief executive officers would be lodged in foreign corporate shells, to be taxed by the United States, if at all, only when remitted to the beneficial owners. In short, to preserve the integrity of the individual income tax system, mobile income of various kinds must be taxed currently. This much is agreed and was reflected in the recommendations we offered in chapter 4.

With respect to the taxation of “active” business profits from overseas sources, however, the competing plans move in opposite directions. The President’s Advisory Panel on Federal Tax Reform (2005) released a plan that would exempt active foreign business income from US taxation altogether, while maintaining current taxation of “mobile income.” The panel argued that its plan would improve the competitiveness of US firms operating abroad and remove the bias against repatriation of overseas income.² Like any territorial system, the panel’s plan would create incentives to shift income to low-tax jurisdictions and would thus need vigorous enforcement of transfer pricing rules and other antiabuse measures.

By contrast with the President’s Advisory Panel, Grubert and Altshuler (2006) recommend moving the United States firmly toward current worldwide taxation for all foreign-source income by eliminating deferral for active business profits earned abroad. According to Grubert and Altshuler, because all income that US-based MNEs earned would be taxed at the same rate, their plan would greatly reduce tax-planning incentives and the complex administrative measures needed to police transfer pricing, interest stripping, and other income-shifting schemes. Their argument is largely but not entirely correct. It assumes that foreign tax authorities would recognize all expenses allocated by the Internal Revenue Service (IRS) to foreign income as a legitimate business deduction. In the past, however, this has not been the case. When foreign authorities deny a deduction for an expense allocated by the United States, the expense is stranded and may have no value for reducing corporate income taxes in any jurisdiction. Moreover, because the foreign tax-credit limit remains a feature of the Grubert and Altshuler plan, income shifting would still appeal to firms in an excess-credit position.³

2. The panel’s plan is similar to that proposed by the Joint Committee on Taxation (JCT 2005), summarized in appendix A3. Grubert and Altshuler (2006) review the panel’s plan and pronounce it preferable to the current system, though it differs sharply from the worldwide taxation concept that they finally endorse.

3. Grubert and Altshuler (2006) estimate that 30 percent of total foreign-source income would be in an excess-credit position. Oil and gas corporations dominate the likely list of excess-credit companies.

David Rosenbloom (2001) takes a different tack. He would divide the world between normal and low-tax jurisdictions and distinguish between “active” and “passive” income. “Passive” or “mobile” income, wherever earned, would be taxed currently by the United States, allowing foreign tax credits for both direct and indirect (“deemed-paid”) foreign taxes. However, in Rosenbloom’s plan, “active” business profits earned by US affiliates operating in normal jurisdictions would be exempt from US taxation. US expenses allocated to the exempted income could not be deducted from US income, and no foreign tax credits would be allowed on such income. On the other hand, all business profits, “active” or “passive,” earned in low-tax jurisdictions—not only classic tax havens but also countries such as Ireland and Singapore—would be taxed currently by the United States, and foreign tax credits would be allowed on this income.

Martin Sullivan (2006) embraces Rosenbloom’s approach. He observes that in 2004, US affiliates in low-tax jurisdictions—those with statutory tax rates 20 percentage points or more below the US rate—reported 30 percent of before-tax profits of all US affiliates, though they had only 13 percent of property, plant, and equipment and only 15 percent of employment. To Sullivan, the contrast is ample evidence of tax avoidance, harmful not only to US fiscal revenues but also to production and employment in the United States.

Based on one version of their capital ownership neutrality paradigm (the NON variant), Desai and Hines (2004) argue that the United States should eliminate its taxation of active business income earned abroad, whether it is earned in normal or low-tax jurisdictions. The goal of capital ownership neutrality is to ensure that no MNE, whatever its home base, is disadvantaged by home-country taxation when it acquires a subsidiary abroad. This prescription suggests a territorial system as a solution; otherwise, a US MNE would be disadvantaged as a potential bidder for a subsidiary firm abroad if it faced competition from a foreign MNE from an exemption country. Because the capital ownership neutrality paradigm is drawn broadly, Desai and Hines do not delve into the details of allocating expenses or avoiding abuse.

Grubert and Altshuler (2006), Rosenbloom (2001), Sullivan (2006), and kindred scholars make a strong case, but in our view, it rests on a fundamental flaw, namely, that a desirable state of worldwide tax affairs would include corporate taxation modeled along the lines of Organization for Economic Cooperation and Development (OECD) experience.

For reasons spelled out in earlier chapters, we are not enamored of corporate income taxation, nor do we believe that the United States can persuade emerging countries to adopt the OECD tax model simply by imposing the US tax on corporate income earned in low-tax jurisdictions. Instead, we urge the United States to adopt a tax system that advances US interests rather than curtailing the presence of US affiliates in low-tax countries.

In short, we sympathize with the goals of the paradigm advocated by Desai and Hines but perhaps not with the particulars of their approach. We believe that US tax policy should foremost seek to retain and capture headquarters activity. This goal implies not only a shift toward a territorial system but also favorable expense allocation rules. At stake are interesting and well-paying jobs, externalities in human capital formation, opportunities to project cultural values around the world, and the national security advantages of being a nerve-center country.

The current US tax regime contains three features that create an inhospitable tax environment for headquarters activities of US-based MNEs: (1) an incentive to locate high-technology production abroad; (2) unfavorable expense allocation rules; and (3) an unfavorable tax climate for production and sales income earned abroad. A territorial system of taxation addresses all three of these defects.

Critics fear that under a territorial system, low foreign tax rates would induce US firms to shift production activity overseas at the cost of domestic investment and employment. Of particular concern are the low-tax and tax-haven countries identified in table 6.2. In an important dimension we agree with this concern: The current system provides an unintended but very strong incentive for US-based MNEs to locate high-technology production outside the United States, as royalties and fees earned from production in tax-preferred locations abroad pay a much lower total tax rate—foreign plus US—than do royalties and fees earned from production in the United States. Retaining the present US tax system involves another danger as well, namely, that an unfavorable climate will drive headquarters activity to foreign locations. Underlying forces—rapid growth and cost advantages—are leading inevitably to a larger share of MNE production activity in China, India, Brazil, and other emerging countries, even if the US tax bias that favors high-technology production abroad is eliminated.⁴ On top of this natural shift, an unfavorable US tax climate for far-flung production and sales activity could prompt US MNEs to shift their headquarters activities to sites abroad as well, encouraging nascent firms to incorporate outside the United States. In other words, as we see the world, the central policy question is whether the United States is adding a tax push to the growth pull of foreign locations. The possibility that a tax push might accelerate the loss of MNE headquarters operations in US cities cannot be lightly dismissed.

4. General Electric, for example, announced its intention to raise the proportion of its overseas production from 41 to over 50 percent by 2009. GE executives cited the relative cost and availability of US engineers versus their counterparts in high-growth, low-cost countries such as China and India as a key factor in their decision (“GE to Shift Output from US,” *Financial Times*, July 27, 2006, 15).

Table 6.2 Operations of US multinational enterprises in low-tax and tax haven countries as a share of total operations (percent)

Country	Total assets	Net property, plant, and equipment	Sales	Net income	Compensation of employees	Employees
All low-tax and tax haven countries ^a						
1982	22.1	4.8	11.9	27.1	3.4	3.7
2004	26.0	6.3	16.8	33.5	5.7	5.0
Major low-tax countries, 2004 ^b	10.5	4.8	13.7	18.5	5.2	4.7
Hong Kong	1.8	0.7	1.9	2.1	1.1	1.4
Ireland	3.4	1.7	3.7	7.6	1.3	1.0
Panama	0.1	0.2	0.1	0.1	0.1	0.2
Singapore	1.6	1.3	3.8	3.6	1.1	1.3
Switzerland	3.6	0.9	4.2	5.1	1.6	0.8
Selected tax haven countries, 2004 ^b	15.3	1.4	2.9	14.8	0.4	0.3
Bahamas	0.2	0.1	0.1	0.1	0.0	0.0
Barbados	0.2	0.0	0.1	0.6	0.0	0.0
Bermuda	5.3	0.6	1.5	6.1	0.1	0.0
Liberia	0.0	0.1	0.1	0.1	0.0	0.1
Luxembourg	5.9	0.2	0.3	4.7	0.2	0.1
Netherlands	0.6	0.0	0.0	0.7	0.0	0.0
Antilles						
UK Caribbean Islands	3.1	0.4	0.8	2.5	0.1	0.1

a. Total 1982 and 2004 values for tax havens include information for Andorra, Anguilla, Antigua, the Bahamas, Bahrain, Barbados, Belize, Bermuda, Cyprus, Dominica, Gibraltar, Grenada, Hong Kong, Ireland, Jordan, Lebanon, Liberia, Liechtenstein, Luxembourg, Macau, Malta, the Netherlands Antilles, Panama, Singapore, St. Kitts, St. Lucia, St. Vincent and the Grenadines, Switzerland, the UK Caribbean Islands, and Vanuatu.

b. Totals may differ from the sum of country entries due to rounding.

Sources: For 2004, Bureau of Economic Analysis, US Direct Investment Abroad: Financial and Operating Data for US Multinational Companies, available at www.bea.gov; for 1982, Hines (2004).

Table 6.3 outlines major differences between US taxation of international income and the systems of several competitors. The United States already embraces many territorial elements under the nominal umbrella of worldwide taxation, but other countries have moved even closer to a territorial system. The United States defines passive income (subpart F of the Internal Revenue Code) more broadly than do Japan, Germany, and France; the United States does not allow a tax-sparing credit to its MNEs, unlike Japan, Germany, the Netherlands, France, and many other OECD countries (Hines 1998);⁵ and the United States requires its MNEs to attribute a greater proportion of their research, development, and experimentation (RD&E) and administrative costs to overseas operations. In practice if not in form, the tax systems of Brazil, China, India, and other emerging industrial powers are probably as lenient as the Netherlands toward foreign income earned by their MNEs.

The Territorial System

Under a territorial system, the United States would tax business income earned from production and sales in the United States but not business income earned by US firms from production and sales in foreign countries.⁶ This step would put US MNEs on a competitive tax footing with their European and Asian counterparts in terms of production in third countries.⁷

Explicit US adoption of a territorial system would undoubtedly trigger repercussions in other countries. No longer could nations justify their

5. A tax-sparing credit is a credit for taxes waived by the host country, ordinarily as part of an industrial development program. If the United States entered into tax-sparing treaties, US MNEs could compete in countries such as Brazil on equal tax terms with Japanese or German multinationals. Hines (1998) studied the effect of tax-sparing on the location and performance of foreign direct investment (FDI) and found that Japanese firms are subject to significantly lower tax rates than are American counterparts in countries with which Japan has tax-sparing agreements.

6. The distinction for tax purposes between incorporated subsidiaries and unincorporated branches would be eliminated, as the parent firm would choose between them under the current section 7701 regulations (the so-called check-the-box regulations).

7. A territorial system would also reduce tensions in the day-to-day business operations of joint ventures because important cash management and investment decisions would no longer raise subpart F issues for the US venturer. Also, the disposition of jointly held businesses would create fewer tax problems. According to the New York State Bar Association (NYSBA 2002), the venturer based in a territorial system could realize its proceeds from the sale of a business without home country tax, while the US MNE, under the current tax system, could not. Differences of this type have killed transactions that otherwise made nontax economic sense.

Table 6.3 Comparison of systems for taxing foreign-source income

Item	United States	Japan	Germany	France	Netherlands	Brazil	China	India	Singapore
Tax jurisdiction	Global	Global	Partially territorial	Territorial	Territorial	Global in form	Partially territorial	Global in form	Territorial
Exemption of foreign-source income	No	No	Yes ^a	Yes ^b	Yes ^c	No	No	No	Yes
Deferral of foreign-source income	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes
Current taxation of tainted income	Yes, under subpart F, foreign investment Company or the personal holding company regime	Yes	Yes ^d	Yes, for "privileged tax system" countries; test is "business conducted abroad"	Yes ^e	Yes	Yes	Yes	Yes, except for dividends, branch profits, and service income from countries with less than 15 percent rate, upon repatriation
Foreign tax credit ^f	Against only federal tax	Against both federal and local tax ^g	Against only federal tax	Against only federal tax ^h	Against only federal tax	Yes	Yes	Yes	Yes

Foreign tax credit limitation	Overall; basket-of-income limitations	Overall ⁱ	Varies by country	n.a.	Overall	Overall; excess credits offset social contribution on profits	Overall	Overall	Overall
Carry-forward of excess credit	10 years	3 years	None	n.a.	None	None	None	None	None
Carry-back of excess credit	1 year	3 years	None	n.a.	None	None	None	None	None
Foreign subsidiary investment in home country, including loans to the parent	Generally taxed as a deemed dividend (Sec. 956)	Not taxed	Not taxed	Not taxed	Not taxed	Not taxed	Not taxed	Not taxed	Not taxed
Tax-sparing credits	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Allocations of deductions to foreign-source income for purposes of determining the foreign tax credit	Yes (see appendix A8)	Yes ^j	No specific rules	n.a.	No specific rules	No specific rules	No specific rules	No specific rules	No specific rules

(notes and sources next page)

Notes to table 6.3

n.a. = not available

- a. Exemption method de facto applies under domestic German law for dividends (95 percent exemption) and by treaty for branch and dividend income (full exemption).
- b. Foreign dividends are taxable, or 95 percent exempt if an election for participation exemption is filed; foreign-branch income is generally fully exempt (there are four limited exceptions to this rule, including branches of French companies organized in tax havens).
- c. Foreign dividends are exempt under the “participation exemption” regime except for dividends received from “low-taxed passive subsidiaries” (generally, subsidiaries where more than 50 percent of their profits consist of portfolio type investments and their tax burden does not amount to at least 10 percent of their profits). Branch income earned by a Dutch resident company is subject to Dutch corporate tax, but such tax is effectively avoided by reducing the worldwide Dutch tax imposed on the company by the ratio of foreign income (subject to foreign income tax) to total worldwide income.
- d. Taxation of low-taxed “base-company income” of a controlled foreign corporation (CFC) is current. “Low tax” is defined as an effective tax rate of less than 25 percent; base-company income is generally defined as passive income; and a CFC is defined as 50 percent (vote or value) or more ownership by German residents.
- e. Foreign dividends (if not exempt under the “participation exemption” regime), interest, and royalties are taxable but relieved by Dutch tax treaties or unilaterally if the payer of the income is a resident of a designated developing country.
- f. All global systems limit the foreign tax credit in terms of the ratio that foreign-source income bears to total income times the precredit tax liability on total income.
- g. The credit against the local tax is limited to 5 percent (in the case of the prefectural inhabitants tax) or 12.3 percent (in the case of the municipal inhabitants tax) of the federal tax credit statutory limit.
- h. Individuals are allowed a deduction for qualifying foreign taxes paid. In practice, French companies are rarely subjected to French tax on overseas income unless operating in a “privileged tax system” where foreign tax paid is very small.
- i. Credit is limited to 90 percent of tax liability on worldwide income.
- j. In computing foreign-source income, specifically allocable expenses are deducted from foreign-source gross income. General and administrative costs and other common expenses are apportioned on a reasonable basis. Interest expense is apportioned on the basis of foreign assets to total assets.

Sources: BNA Tax Management’s Tax Management Portfolio 962-2, Business operation in Germany, 2007; Tax Management Portfolio 973-2, Business operation in the Netherlands, 2007; Tax Management Portfolio 969, Business operation in Japan, 2005; Tax Management Portfolio 961-2, Business operation in France, 2007; Tax Management Portfolio 966-3, Business operation in India, 2006; Tax Management Portfolio 957-2, Business operation in the People’s Republic of China, 2006; Tax Management Portfolio 954-3, Business operation in Brazil, 2006; Tax Management Portfolio 983-3, Business operation in Singapore, 2007; www.fei.org (accessed September 4, 2005); Billings (1990); Joint Committee on Taxation (JCT 2006).

corporate taxes by arguing that revenue was simply being transferred from the US Treasury and not from corporate coffers. Grubert and Altshuler (2006) contend that, as the leading economic power, the United States has an obligation to hold an umbrella over foreign tax systems, in essence sheltering them from competition. We disagree. Given the rise of MNEs based outside the United States, we think that the US umbrella has too many holes to provide effective shelter, and we do not think creating a new umbrella from OECD fabric is feasible.

We acknowledge that a US move toward territoriality would exert a downward force on corporate income taxation worldwide (Mullins 2006). In our view this would be a good outcome, as it could relieve the excessive taxation of capital that now characterizes many fiscal systems. Meanwhile, so long as it remains in place, the tattered US tax umbrella disadvantages the United States as a location for corporate headquarters and preferentially encourages high-technology production abroad. Our specific recommendations for shifting toward a territorial system entail the following changes:⁸

- Dividends and interest received by a US parent corporation owning more than 50 percent of the voting shares of an active foreign corporate subsidiary would be exempt from US taxation. The same rule would apply to unincorporated branch profits and capital gains from selling such branches and affiliates. No foreign tax credits would arise from the enumerated income streams.⁹ For US tax purposes, neither the foreign operating losses of these affiliates nor foreign capital losses incurred in selling shares or assets would be recognized.
- If a foreign affiliate did not meet a stringent active business test, the United States would currently tax all of its income, whether it was distributed as dividends, interest, or repatriated branch earnings. The reason for enunciating a bright line distinction between active and passive foreign operations is to discourage firms from sheltering portfolio income earned abroad from residence taxation in the United States.

8. Our proposal is similar in several respects to the international business tax proposal laid out in chapter 6, “Simplified Income Tax Plan,” of the final report of the President’s Advisory Panel on Federal Tax Reform (2005). See appendix A3.

9. There are two reasons not to include controlled foreign corporations (CFCs) owned 10 to 50 percent by a US parent corporation in the exemption system. Doing so would open the door for passive investors holding, say, 25 percent of the shares, to take advantage of the territorial exemption. And it is more likely that a US parent corporation with a majority stake would carry on significant headquarters operations in the United States.

- When the United States taxed the passive earnings of foreign affiliates currently, a foreign tax credit would only be allowed for foreign withholding taxes actually paid on remitted dividends, interest, and branch earnings. Unlike current law, no indirect (or deemed-paid) foreign tax credit would be allowed for underlying taxes imposed by the host country on corporate earnings. The rationale for ensuring current US taxation of passive operations, and for disallowing the indirect foreign tax credit, is that the US parent corporation could have chosen to receive the income streams directly without channeling them through another country. Hence there is no reason for the United States to share its tax revenue with a host country through the indirect foreign tax credit. Moreover, the foreign tax credit for any foreign withholding tax on repatriated income should be capped at 10 percent and eventually phased out (see chapter 4). The parent company receiving passive income could still deduct foreign withholding taxes.
- A low threshold of tainted income would cause a foreign affiliate to fail the active business test. Tainted income would include net interest income (interest receipts minus interest payments); dividends from unrelated companies; lease income on moveable equipment, such as airplanes, ships, and drilling rigs; and royalty and fee income payable for the use of intellectual property rights.
- Capital gains on the sale of an active foreign affiliate owned more than 50 percent (or from the sale of a foreign branch) by US parent firms would be exempt from US taxation, and no foreign tax credit would be permitted for such capital gains. Capital gains realized on the sale of other foreign assets would be fully taxed in the United States, but a foreign tax credit for the source-country withholding tax would be allowed, capped at 10 percent. As with passive dividends and interest, the foreign tax credit for withholding taxes on capital gains should eventually be phased out (though a deduction would be allowed). The United States would not recognize capital losses incurred by selling an active business subsidiary or branch. However, capital losses incurred on the disposition of other foreign assets could be used (as under current law) to offset capital gains.
- All RD&E incurred in the United States would be deductible against US business income, provided the firm claiming the deduction owns the resulting intellectual property. After a reasonable period of experience with the new system, the Treasury would assess the net US income or loss, and thus US tax revenue collected or foregone, from licensing or selling intellectual property to foreign firms. Armed with this information, Congress could periodically evaluate the merits of the approach we have advocated.

- General and administrative expenses (G&A) incurred in the United States (management, legal, financial, and accounting) would be fully deductible against US business income. This would encourage locating headquarters activities in the United States. As with RD&E, Treasury and Congress would evaluate the consequences of allocating G&A solely to US business income after a period of experience with the new system.
- Foreign royalties and fees paid to a US company and foreign purchases of intellectual property rights would be taxed by the United States, but a foreign tax credit would be allowed for source-country withholding taxes, capped at 10 percent.¹⁰ Because market prices seldom exist to use or sell intellectual property rights or administrative services, and because US parent firms will be tempted to characterize taxable royalties and fees as exempt dividends and interest, the IRS should continue to support a well-staffed antiabuse unit to monitor such income flows.
- There are two reasons to allow a permanent foreign tax credit, capped at 10 percent, for withholding taxes on royalties, fees, and the sale of associated intellectual property rights but not for passive interest and dividends. First, the claim of the source country regarding creating a profitable market for applying intellectual know-how seems stronger in the case of royalties and fees. Second, imbalances between the United States and developing countries regarding flows of intellectual property income are extreme, making some concession to source-country taxation politically necessary.
- Interest expenses incurred by US parent firms would be allocated in part to exempt dividend and interest income received from active foreign affiliates. The amount so allocated would be disallowed as a deduction from US business income. Unlike RD&E and G&A expenses, we see no benefit to the United States in encouraging US parent firms to act as bankers for their active foreign affiliates, as the return-income flows of dividends and interest would be exempt under a territorial system.
- To ensure the global competitiveness of US banks, insurance companies, and kindred companies, bona fide financial institutions would qualify for safe-haven rules as if they were conducting an active business through their foreign affiliates, even though they earn

10. As necessary, US tax treaties would be renegotiated to reflect the 10 percent cap on creditable withholding taxes.

otherwise tainted income.¹¹ Stringent rules would identify eligible financial institutions.¹²

- The foreign-source portion of export earnings would be exempt from US taxation. Foreign base company sales income and foreign base company service income, now subject to US taxation under the provisions of subpart F, would no longer be regarded as tainted income.
- This study does not address the taxation of wage and salary income earned abroad. However, we suggest that the foreign tax credit continue to be available to individuals, so long as the United States maintains its historic posture of taxing the worldwide income of US citizens and residents. Of course, all US citizens and residents should be subject to current US taxation of their portfolio income, including capital gains, whether earned from US or foreign sources.

Adopting a territorial system with such features would place US-based MNEs in the same position as most of their foreign competitors. At the same time, it would greatly simplify taxation of international income. In the next few sections we highlight advantages of the proposed reforms.

Tax Bias Against RD&E and G&A Activity

Over the years, the United States has tinkered frequently with its tax treatment of RD&E expenses incurred in the United States, typically by changing the percentage allocable to foreign-source income. Under the current system, any RD&E expense allocated to foreign-source income reduces the foreign tax credit limit, thus working as a penalty on companies in an excess-credit position. Seldom does a company enjoy compensating tax

11. Section 954(h), added by the Tax Relief Act of 1997 on a temporary basis, generally excludes from taxation under subpart F foreign income derived by a financial institution in the active conduct of its business. This provision was the center of controversy at the time it was enacted. President Bill Clinton thought that the exemption was too broad and decided to use the line-item veto to eliminate the active financing income provision contained in the Taxpayer Relief Act of 1997. However, the Supreme Court held the line-item veto to be unconstitutional (*Clinton v. City of New York*, 118 S. Ct. 2091). Congress modified and extended the active financing exception as part of the Tax and Trade Relief Extension Act of 1998 (PL 105-277), but applied the provision only to tax years beginning in 1999. The Ticket to Work and Work Incentives Improvement Act of 1999 (PL 106-170) provided another two years of relief. On March 9, 2002, President George W. Bush signed the Job Creation and Worker Assistance Act of 2002 (PL 107-147), which extended the active financing exception through December 31, 2006. The Tax Increase Prevention and Reconciliation Act of 2005 (PL 109-222) extended this exception through January 1, 2009.

12. One rule worth considering is that a US corporate group should pay at least 80 percent of its distributed interest and dividends to unrelated parties to be considered a bona fide financial institution. That way, a bona fide financial institution could not be nested within a larger MNE corporate group, functioning as a clearing house for loans between group members.

relief abroad: Foreign jurisdictions rarely recognize the allocated expense as a legitimate business deduction, as the RD&E activity took place in the United States.

By contrast with the US approach, other industrial countries typically allow 100 percent of RD&E expenses incurred domestically to be allocated to domestic income (PricewaterhouseCoopers 1991, 118). Between 1981 and 1985 Congress mandated a similar 100 percent allocation rule. In the same spirit, we propose that 100 percent of RD&E expense incurred domestically be allowed as a deduction against US business income. In our view, the revenue losses incurred when RD&E expenditures take place on US soil will ordinarily be recouped when foreign royalties and fees are paid to US parent firms. We may be too optimistic, and if so the tax rule could be revised after a reasonable period for evaluation. Meanwhile, disallowed deductions for RD&E expense will not be a cause for MNEs to relocate their research activities to offshore locations.

Similar arguments apply for a rule that allows the deduction of 100 percent of G&A expenses, which include compensation for top executives plus outlays for departments devoted to finance, accounting, engineering, legal, and similar activities. Currently G&A expenses are divided between US- and foreign-source income, even though, as with RD&E expenses, foreign jurisdictions seldom recognize the part allocated against foreign income as a deduction because the activity took place in the United States. Hence, under current rules, MNEs may incur a slight tax disadvantage by carrying out headquarters functions in the United States. In our view, all G&A expense for activity conducted in the United States should be deductible against taxable corporate income. This will encourage the siting of headquarters activity in the United States. Again, as with RD&E, the Treasury should monitor the relationship between G&A expenses incurred and fees collected by the parent company. As necessary, the tax rule could be revised after a reasonable period for evaluation.

Tax Bias Against US Production

Under the current foreign tax credit system, excess credits on foreign corporate earnings can be used to shield technology income from US taxation through a process known as cross crediting.¹³ Royalties and management

13. Cross crediting is largely a feature of the overall limit on the foreign tax credit, as opposed to the per-country limit (Hufbauer 1992). Bergsten, Horst, and Moran (1978, chapter 6) joined other commentators in recommending a per-country rather than an overall limit on the foreign tax credit. From the standpoint of tax neutrality, the argument runs that it makes no sense to shelter production and profits in low-tax country B from US corporate taxation by way of foreign tax credits derived from production and profits in high-tax country A. The Tax Reform Act of 1986, with its baskets-of-income approach, moved toward Bergsten, Horst, and Moran's recommendations, but the AJCA of 2004 returned almost completely to the previous system.

fees are often subject to little or no tax in the foreign country in which the license or service is used. Under the network of US tax treaties, withholding rates are usually set at zero or 5 percent. However, under current law, because royalty and fee income streams are grouped in the general limitation basket, they can absorb excess foreign tax credits generated by other high-taxed general limitation income. The result is that the United States collects almost no tax on foreign royalties and fees.

Because of these interactive tax features, royalties and fees earned abroad are often taxed at a lower rate than comparable technology income earned in the United States. This creates a perverse incentive to exploit intellectual property overseas rather than in the United States. Consolidating the number of foreign tax credit baskets from nine to two, beginning in 2007 under the American Jobs Creation Act (AJCA), increases the opportunities for cross crediting, giving further incentive to exploit technology abroad rather than in the United States.

To illustrate, royalties and fees paid by a Japanese subsidiary to a US parent corporation would be fully deductible from the Japanese firm's corporate income (taxed at a 40.7 percent tax rate in 2005) and would not be taxed by Japan when paid to the US parent firm.¹⁴ If the US parent were in an excess foreign tax-credit position from foreign taxes incurred on dividend income from Japan, Germany, or elsewhere, the royalty and fee income would then garner a zero US federal tax.¹⁵ In contrast, technology income earned from producing the same item in the United States would be taxed, like other corporate income, at a 35 percent federal rate—about 40 percent in total, including state corporate income taxation.

The rising commercial importance of intangible assets, along with royalty and fee income, makes the tax policy toward them an important issue.¹⁶ During the 10-year period between 1996 and 2005, US MNEs increased their receipts from exports of goods and services by 50 percent, but increased their receipts from exports of technology—namely,

14. Article 12 of the 2004 US-Japan tax treaty establishes a zero withholding rate.

15. Moreover, the US parent corporation can usually arrange its affairs to receive technology income from abroad through a US subsidiary incorporated in a state (such as Delaware) that does not tax such income.

16. Like ourselves (see Hufbauer 1992), Fleming and Peroni (2004) regard the ability of US MNEs to lower their effective US tax rate of foreign royalty and fee income through cross crediting as fundamentally inconsistent with the core purpose of the foreign tax credit provisions. Grubert and Mutti (2001, 35) similarly conclude that “the taxation of this royalty stream from abroad will affect the advantage of foreign investment compared with exploiting the intangible or making some other investment in the United States, where the return would be fully taxable.”

royalties and license fees—by 73 percent.¹⁷ The use abroad of US technology is generally good for both US firms and the world economy, but we see no sense in a tax bias that encourages high-technology production abroad at the expense of high-technology production in the United States.

Tax Bias Against Repatriation

By shifting to a territorial system, US MNEs would no longer need to calibrate dividend repatriations to minimize their US tax liability or use hybrid entities to avoid subpart F rules. More important, US MNEs would not forgo investment opportunities in the United States for the sake of avoiding taxes (Grubert and Mutti 2001).

Under the current system, parent corporations can defer paying US tax on foreign-source income by a simple device: not repatriate dividends from their foreign affiliates. This creates a tax incentive for US companies to hold income overseas, even though it could earn better returns if repatriated and invested in the United States. A recent “experiment” suggests that the bias against repatriation could be substantial. As part of the AJCA, the tax on dividend repatriations was temporarily lowered to 5.25 percent for calendar year 2005, and Federal Reserve data indicate a very strong response: Repatriated foreign profits shot up from \$35 billion in 2004 to \$217 billion during the tax holiday in 2005, a spike of more than 600 percent.¹⁸

If the policy were made permanent, the huge increase seen in 2005 would not be maintained, as repatriated earnings in 2005 represent both pent-up unrepatriated profits from past years and tax planning for future years. However, the spike confirms that current US tax policy suppresses the repatriation of income to the United States. Since a territorial system would no longer tax repatriated dividends, the incentive to keep funds overseas for tax planning purposes would be removed, possibly increasing the long-term flow of investment dollars to the United States. Moreover, as stated above, shifting toward a

17. Total exports of goods and services from the United States were \$1,275 billion in 2005 compared with \$851 billion in 1996. Total receipts of royalties and license fees amounted to \$57 billion in 2005 compared with \$33 billion in 1996. See Bureau of Economic Analysis, *Survey of Current Business*, International Data, Table E.1 (December 2006) and Table F.1 (December 1998), available at www.bea.gov.

18. Experienced tax practitioners believe that the Federal Reserve Data flow of funds data substantially understates the actual spike in repatriations. See Federal Reserve Flow of Funds, table F7, 2006, available at www.federalreserve.gov.

territorial system would simplify the complex US system of taxing international income.¹⁹

The “Runaway Plant” Specter

An old argument against territorial taxation, advanced in the Burke-Hartke debate of the 1970s (see appendix A1) and echoed today when Lou Dobbs denounces offshore outsourcing, is the specter of “runaway plants.” Instead of making goods and services in the United States and selling them abroad, so it is said, “disloyal” and “greedy” US corporations make products abroad for sale into the US market, and they would do more of the same under a territorial tax system (JCT 2003b) because the shelter from US taxation of overseas income would become more secure.

Such fears are exaggerated. Four aspects of the international economy must be considered to evaluate the true dimensions of the specter of the “runaway plant”: the “home bias” of US-based MNEs, the export consequences when US firms produce abroad, the impact of tax changes on US investment, and the potential competition between US-based MNEs and foreign firms in serving the US market.

“Home Bias” and US Employment

Despite globalization, US-based MNEs still exhibit a strong home bias, conducting the bulk of their activities and hiring most of their workforce in the United States.²⁰ As described in table 6.4, in 2004 US parent firms accounted for 68 percent of sales by the MNE corporate group and 71 percent of its capital expenditures, and US-based MNEs employed 72 percent of their worldwide workforce in the United States. All of these ratios have slowly declined over the past two decades (again see table 6.4)

19. In February 2005 Thomas Neubig, national director of quantitative economics and statistics for Ernst & Young LLP, Washington, unveiled a survey of 41 large US MNEs, 25 of which are Fortune 100 companies. The survey showed that transfer pricing, the foreign tax credit, and subpart F issues are among the greatest challenges for compliance. Nearly 70 percent of the companies said that the United States has the highest income tax and compliance costs, followed by the United Kingdom, France, Brazil, and Germany. According to the survey, Singapore, Ireland, Hong Kong, Japan, and Switzerland were listed as having the lowest costs. See “Experts, Practitioners Call for Changes to Liberalize US International Tax Rules,” *Daily Tax Report*, February 11, 2005, available at www.bna.com. However, even with the reforms we recommend, the international dimension of the US tax system would remain a far cry from the simplicity claimed by flat-tax advocates.

20. By contrast, among the top 100 MNEs worldwide, it is commonplace for more than half of sales, assets, and employees to be located outside the home country. See table II.1 in United Nations Conference on Trade and Development, *World Investment Report 1998* (UNCTAD 1998).

Table 6.4 Employment, capital expenditure, and sales by nonbank US multinational enterprises (MNEs), 1988–2004

Year	Employees				Capital expenditure				Sales ^a			
	US MNEs total	US parents	Foreign affiliates	Share of employees by US parents	US MNEs total	US parents	Foreign affiliates	Share of expenditure by US parents	US MNEs total	US parents	Foreign affiliates	Share of sales by US parents
	(thousands)			(percent)	(billions of dollars)			(percent)	(billions of dollars)			(percent)
1988	22.5	17.7	4.8	79	223.8	177.2	46.6	79	3,756.1	2,828.2	927.9	75
1990	23.8	18.4	5.4	77	274.6	213.1	61.5	78	4,452.0	3,243.7	1,208.3	73
1992	22.8	17.5	5.3	77	272.0	208.8	63.2	77	4,622.5	3,330.9	1,291.6	72
1994	24.3	18.6	5.7	77	303.4	231.9	71.4	76	5,425.9	3,990.0	1,435.9	74
1996	24.9	18.8	6.1	76	340.5	260.0	80.5	76	6,347.6	4,479.0	1,868.6	71
1998	26.6	19.8	6.8	74	411.2	317.2	94.0	77	6,942.0	4,970.1	1,971.9	72
2000	32.1	23.9	8.2	74	506.9	396.3	110.6	78	9,202.6	6,695.2	2,507.4	73
2002	30.4	22.1	8.3	73	443.4	333.1	110.3	75	8,853.4	6,337.8	2,515.6	72
2004	29.6	21.3	8.3	72	438.2	310.9	127.3	71	10,148.6	6,866.1	3,282.5	68

a. Total MNE sales figure double counts sales between affiliates and their parents.

Source: Bureau of Economic Analysis, news release, April 20, 2006, Summary Estimates for Multinational Companies: Employment, Sales, and Capital Expenditures for 2004, available at www.bea.gov (accessed December 1, 2006).

because many foreign countries, especially in Asia, are growing faster than the United States. But it cannot be argued that the predominance of US activity and employment in the global MNE picture reflects the discipline of a capital export neutrality (CEN) tax system because, as we have seen, US tax collections on overseas income are very small.

Considering only taxes, the feared “runaway-plant” outcome of a territorial system is possible. But so far, if the phenomenon exists, it is barely apparent. In its crudest form, the “runaway plant” argument suggests a one-for-one trade-off: One job gained in an MNE abroad translates into one job lost in the United States. Individual instances may be cited of this outcome, but aggregate statistics fail to reveal a wholesale relocation of jobs to foreign production plants. As table 6.4 shows, US affiliates abroad increased the number of foreign employees from 4.8 million in 1988 to 8.3 million in 2004, a gain of 3.5 million workers. Meanwhile, their US parent firms increased their number of US employees from 17.7 million to 21.3 million, a gain of 3.6 million workers. The rate of job expansion abroad was clearly faster than at home, and consequently, the share of total MNE employment accounted for by US parent firms dropped from 79 percent in 1988 to 72 percent in 2004. But there was no one-for-one trade-off between jobs abroad and jobs in the United States.

To be sure, the US share of global MNE employment has declined, if slowly. The main concern flagged by the employment data in table 6.4, however, is not the slow decline in the US parent share of total MNE employment. That can be explained by rapid economic growth in emerging countries. The more troublesome feature is that, since 2000, US parent firm employment has barely increased. But it needs to be pointed out that, between 2000 and 2004 total US employment in the private sector—full time and part time—dropped slightly, from 116.0 million to 115.1 million.²¹ Relative to total private sector employment, US parent firms are holding their own.

Feinberg and Keane (2006) studied the relation between employment by US parent firms and their affiliates, calculating that reducing the Canadian wage rate by 1 percent would increase both Canadian affiliate employment (by 4.2 percent) and US parent employment (by a tiny 0.08 percent). The explanation: A lower Canadian wage reduces MNEs’ total production costs, enabling the enterprises to increase the scale of their operations and thereby slightly increase the demand for US labor. If the

21. This set of comparisons extends the analysis reported by Slaughter (2004). Private employment data comes from the Bureau of Economic Analysis, National Income and Product Accounts, Table 6.4D (August 2006) (available at www.bea.gov). The decline in full-time employment from 105.6 million to 104.5 million accounts for most of the decline in total private employment.

same analysis applies to lower corporate tax costs abroad, it would help to explain why the extreme form of the runaway plant story, a one-for-one trade-off between jobs abroad and jobs at home, has little traction. The bottom line is that lower corporate taxes abroad are not adverse to US employment by US-based MNEs.

Export Consequences

Empirical studies indicate that expanded activity of some US-based MNEs abroad may actually stimulate US merchandise exports; at worst, expanded activity abroad, on average, probably does not undercut US merchandise exports.²²

To cite one prominent study of merchandise export consequences, Graham (2000) found that foreign direct investment (FDI) in US outbound manufacturing is associated with greater US exports and has no significant impact on US imports. They concluded that US outbound FDI in the manufacturing sector does not transfer US production abroad. In an earlier study, Lipsey (1995) surveyed empirical literature and reported that one dollar of overseas production by US affiliates generates \$0.16 of exports from the United States. In a later study, however, Lipsey (2002) reported that no consistent relation could be found between production abroad by a firm and exports either by the investing firm, its industry, or the country as a whole.

Sullivan (2006) examines the trade data under a different lens. He focuses on intracorporate merchandise trade, which in 2004 accounted for \$416 billion (some 18 percent) of US two-way merchandise trade with the world. The total US merchandise trade deficit with foreign affiliates was \$47 billion. Ignoring Canada and Mexico because of their special relationship with the United States,²³ the next eight countries with which the United States had the largest intracorporate bilateral trade deficit, collectively at \$32 billion, had an average effective corporate tax rate of 12 percent. By contrast, the 10 countries with which the United States had the largest intracorporate bilateral trade surplus, collectively at \$26 billion, had an average effective corporate tax rate of 28 percent. Sullivan's quantitative analysis is far from sophisticated, but it suggests that tax considerations bear on intracorporate trade balances and that MNEs

22. Empirical studies have not yet evaluated the impact of expanded MNE production abroad on US exports of services, mainly for lack of data.

23. The United States had a combined intracorporate merchandise trade deficit of \$37 billion with its two North American Free Trade Agreement partners in 2004. However, their average corporate tax rates are similar to those of the United States: a rate of around 31.5 percent for Canada and 33.9 percent for Mexico (Sullivan 2006).

may source a disproportionate part of their US imports from low-tax countries.²⁴

That said, Sullivan's study and others reflect the existing US tax system, which collects around 3 percent of the earnings of all US affiliates operating abroad (see table 6.5). Under a territorial system, the tax burden on active affiliates would be zero—lower but not a lot lower.

Conceivably, the sort of tax system advocated by Grubert and Altshuler (2006), Rosenbloom (2001), and Sullivan (2006) would prompt US-based MNEs to relocate production from low-tax jurisdictions back to the United States because of the sharply higher tax rate that would now be paid on economic activity abroad. However, we think it is more likely that production in low-tax jurisdictions for export to the US market would continue at the same pace as before, but under the umbrella of MNEs based in the United Kingdom, Netherlands, Japan, China, and a number of other countries. In other words, the most relevant comparison is not between taxes paid by a US MNE on production in the United States and production in a low-tax jurisdiction, but rather the tax paid by any MNE on production in a low-tax jurisdiction compared with production in the United States.

In fact, this point can be generalized: If production in a low-tax jurisdiction is an attractive proposition, then economic activity in such locations will not be confined to production for the US market. Companies will gravitate to these jurisdictions to produce goods and services for the entire world market.

Investment Impact

It is perhaps surprising that there is less academic debate over the investment impact of a territorial system than the export impact. Altshuler and Grubert (2001) examined how a dividend exemption system, a form of territorial taxation, would affect the location incentives of US corporations, using two different approaches. Their first approach compared FDI patterns in low-tax with those in high-tax jurisdictions and US-based MNEs with MNEs in two exemption countries, Germany and Canada. Their second approach analyzed the extent to which residual US taxes on low-tax foreign earnings affect the location decisions of US corporations, using microdata from US corporate tax returns. Neither approach

24. In a rigorous study, Feinberg and Keane (2006) showed that adoption of just-in-time (JIT) inventory management systems by US firms helps explain the very rapid growth of intrafirm trade between Canada and the United States in the 1980s and 1990s. In fact, JIT was probably more important than bilateral tariff reductions under the Canada-US free trade agreement as a cause of intrafirm trade growth. Studies such as Feinberg and Keane (2006) caution against attributing excessive influence to tax or tariff regimes to explain trade and investment patterns.

Table 6.5 Actual US income from foreign sources, foreign tax credits, and US tax revenue under current system, 2002^a
(billions of dollars)

Category/type	Foreign gross income flows before allocated deductions	US deductions allocated to foreign income	US taxable income after deductions	Foreign withholding taxes paid or corporate taxes deemed paid		Tentative US tax liability at 35 percent	Foreign tax credit claimed ^b	US tax revenue
				Rate	Amount			
Total repatriated foreign income received by US taxpayers	330.8	185.0	145.8	12.5	41.5	51.0	42.4	8.6
Dividends, including taxes deemed paid	88.3			29.1	25.7			
Dividends	64.1				1.5			
Foreign taxes deemed paid (gross-up)	24.2				24.2			
Interest	44.5			1.3	0.6			
Rents, royalties, and license fees	57.3			4.0	2.3			
Services income	17.1			2.9	0.5			
Other income (including export profits)	123.7			6.3	7.8			
Foreign-branch income ^c	65.8			6.8	4.5			
General limitation repa- triated income (active income)	225.5	111.9	113.6	14.3	32.3	39.8	33.2 ^d	6.6 ^d

(table continues next page)

Table 6.5 Actual US income from foreign sources, foreign tax credits, and US tax revenue under current system, 2002^a
(billions of dollars) (continued)

Category/type	Foreign gross income flows before allocated deductions	US deductions allocated to foreign income	US taxable income after deductions	Foreign withholding taxes paid or corporate taxes deemed paid		Tentative US tax liability at 35 percent	Foreign tax credit claimed ^b	US tax revenue
				Rate	Amount			
Dividends, including taxes deemed paid	67.3			30.3	20.4			
Dividends	47.9				1.0			
Foreign taxes deemed paid (gross-up)	19.4				19.4			
Interest	5.7			1.8	0.1			
Rents, royalties, and license fees	51.6			4.5	2.3			
Services income	15.0			2.0	0.3			
Other income (including export profits)	86.0			7.9	6.8			
Foreign-branch income ^c	33.7			7.1	2.4			
Financial services repatri- ated income (active and passive income) ^d	85.0	64.1	20.9	7.9	6.7	7.3	6.7 ^d	0.6
Dividends, including taxes deemed paid	11.3			30.1	3.4			
Dividends	8.3				0.4			
Foreign taxes deemed paid (gross-up)	3.0				3.0			

Interest	34.9			0.6	0.2			
Rents, royalties, and license fees	4.2			0.0	0.0			
Services income	2.0			10.0	0.2			
Other income	32.6			2.5	0.8			
Foreign-branch income ^c	30.5			6.9	2.1			
Other passive repatriated income	20.3	9.0	11.3	12.3	2.5	4.0	2.5 ^d	1.5 ^d
Dividends, including taxes deemed paid	9.7			19.6	1.9			
Dividends	7.9				0.1			
Foreign taxes deemed paid (gross-up)	1.8				1.8			
Interest	4.0			7.5	0.3			
Rents, royalties, and license fees	1.4			0.0	0.0			
Services income	0.0			0.0	0.0			
Other income	5.2			3.8	0.2			
Foreign-branch income ^c	1.6			0.0	0.0			

a. Repatriated foreign income includes earnings of foreign affiliates that are repatriated to US taxpayers as dividends, interest, rents, royalties, fees, etc. (or deemed repatriated under subpart F). It does not include retained earnings.

b. In all, some \$57 billion foreign tax credits were available in 2002. However, about \$15 billion of the available amount could not be claimed because parent firms were in an excess foreign tax credit position. Importantly, foreign tax credits related to \$16.3 billion in general limitation income arising from oil and gas extraction are subject to special limitations under IRC section 907.

c. Foreign-branch income is counted in the preceding income sources. Therefore, it is not included in the totals to avoid double-counting. However, foreign tax credits arising from foreign-branch income are not included with other sources and instead are counted separately.

d. Foreign tax credit claimed and US tax revenue are both estimated by the authors. In the case of "general limitation" income, we assume that \$0.9 billion of prior year foreign tax credits were carried over and applied in 2002.

Source: Internal Revenue Service, Statistics of Income, Fall 2005, statistical tables for US corporate returns with a foreign tax credit, available at www.irs.gov (accessed on January 8, 2007).

suggests that location decisions would significantly change if the United States adopted a territorial system with respect to dividends from active foreign affiliates.

In another study, Desai, Foley, and Hines (2005) examined the impact of outward FDI on domestic US investment rates using data covering a broad set of high-income countries during the 1980s and 1990s. The authors found that “an additional dollar of foreign investment capital expenditure is associated with 3.5 dollars of domestic capital expenditures by the same group of multinational firms, strongly suggesting a complementary relationship between foreign and domestic investment” (p. 7). Based on these studies, under the current tax system, foreign investment appears to complement domestic investment. A shift to territorial taxation would change incentives little, if at all.

Competition Between MNEs

The United States could tax the active income that US-based MNEs earn overseas, but it could not extend its corporate tax system to embrace the overseas income of German-, Japanese-, or Chinese-based MNEs. The logical consequences are powerful. As long as the United States relies on corporate income taxation, it cannot level the tax field between production abroad and production at home. The fundamental reason is that the United States cannot tax the overseas income of MNEs or purely national firms that are based abroad, even when they sell in the US market. If US-based Microsoft, for example, does not take advantage of the favorable characteristics (including low Indian taxes) of producing software in Bangalore for export to the US market, foreign-based MNEs and local Indian firms will fill the breach. The same wisdom applies to producing tax-advantaged microprocessors by Intel in Ireland or pharmaceuticals by Merck in Singapore.

In this book, we take corporate income tax as a political fact of life. Given an equally strong economic fact of life—competition between MNEs that are home-based in many different countries as well as global competition between purely national firms—we jettison the CEN dream of leveling the corporate tax between production in the United States and production in low-tax jurisdictions.

Antiabuse Measures

A territorial system puts compliance pressure on tax features that distinguish between US- and foreign-source income, and between “active” and “passive” income. While foreign tax credit limitations already require these distinctions, the importance of source rules and the active-passive distinction would be magnified under a territorial system because these rules would affect not only taxpayers who are in an excess-credit posi-

tion—the case under current law—but all taxpayers. The same is true of rules that allocate deductible expenses between taxable income streams, both home and foreign, and exempt income streams (in this context, exempt foreign income).

Regarding tax abuse, it is important to recognize that large firms always have some discretion in characterizing an income stream as “interest,” “royalties,” “fees,” or “dividends;” counting income as active or passive; classifying income as domestic source or foreign source; and attributing expenses to foreign or domestic income. Latitude on these matters exists under the present system and would continue to exist under any new system. Corporate tax departments naturally favor the characterization and classification that leads to the lowest tax payment; under existing law, tax differentials between types and sources of income are already large and would remain so with an exemption system.

Table 6.6 presents US tax differentials between types and sources of income and expense under current law and our proposed territorial system. The existing and proposed systems both feature huge tax-rate cliffs. Under the existing system, whether or not foreign-source income is repatriated can make a difference as large as 30 percentage points in the applicable US tax rate. Whether or not deemed-paid foreign tax credits are cross credited against interest, royalties, and export profits can make a difference of 27 percentage points. Under a territorial system, the distinction between “active” and “passive” income leads to a 30-percentage-point tax difference. The other large difference is between royalties and fees and other types of “active” foreign-source income; again, the tax gap is 30 percentage points.

Under the proposed territorial system, dividends and interest that “active” foreign affiliates pay to their US parents would be exempt from US taxation, along with the foreign-source component of export profits labeled export-source income.²⁵ However, foreign-source royalties and fees, together with lease income and portfolio interest and dividends, would be subject to US tax. There would thus be strong incentives to shift the classification of income using creative transfer pricing and other means. Such abuse cannot be eliminated, but it can be controlled. In this section, we touch on basic provisions that would be necessary to curtail abuse under a territorial system.

Transfer Pricing Abuse

Transfer pricing abuse has been much explored by lawyers and economists, yet practical solutions remain elusive.²⁶ A territorial system would not change the fundamental calculus that makes abusive transfer pricing

25. The current export source rules are summarized in appendix A4.

26. See appendix A9 for a summary of rules on intercompany pricing.

Table 6.6 Illustrative US corporate tax rates at the federal level (after foreign tax credits) by type of foreign-source income

Type of income	Foreign-source income (after allocated US deductions)				Domestic corporate income (post-AJCA)
	Current system		Territorial system		
	Repatriated or deemed repatriated ^a	Not repatriated	Active income	Passive income	
Foreign-source income					
CFC earnings					
Assuming 29 percent FTC for active income ^b	6	0	0	n.a.	n.a.
Assuming 5 percent FTC for passive income	n.a.	0	n.a.	30	n.a.
Interest paid from CFC					
Assuming cross crediting ^c	3	0	n.a.	n.a.	n.a.
Assuming no cross crediting ^d	30	0	0	30	n.a.
Royalties and fees					
Assuming cross crediting ^c	3	0	n.a.	n.a.	n.a.
Assuming no cross crediting ^d	30	0	30	30	n.a.

Foreign-source export earnings					
Assuming cross-crediting ^e	7	0	n.a.	n.a.	n.a.
Assuming no cross-crediting ^f	35	0	0	n.a.	n.a.
Portfolio dividends and interest ^g	25	0	n.a.	25	n.a.
Domestic corporate income ^h					
“Manufacturing” income	n.a.	n.a.	n.a.	n.a.	32
Other income	n.a.	n.a.	n.a.	n.a.	35

CFC = controlled foreign corporation

n.a. = not available

a. Deemed repatriated refers to foreign-source income taxed currently under subpart F, even if not repatriated.

b. In 2002 the foreign tax credit (FTC) for general limitation income (active income) was about 29 percent (see table 6.8) on grossed-up dividends. The FTC rate may have declined since, because foreign corporate tax rates are falling.

c. Assuming cross crediting of deemed paid foreign tax credits in the general limitation basket at a rate of 29 percent, plus a 5 percent foreign withholding tax credit under the current system.

d. Assuming only a 5 percent foreign withholding tax credit under both the current and territorial systems.

e. Assuming cross crediting of foreign tax credits in the general limitation basket at a rate of 29 percent and no foreign withholding tax under the current system.

f. Assuming no foreign withholding tax under the current system. Foreign-source export earnings would be exempt under the territorial system.

g. Assuming a 10 percent foreign withholding tax. By definition, portfolio dividends and interest are passive income under the territorial system.

h. “Manufacturing” income, broadly defined, will be subject to a rate of 32 percent after 2010. Other corporate income, including income from foreign sources, will continue to pay 35 percent before tax credits, including the foreign tax credit.

so attractive to corporate tax departments. Firms would still have an incentive to both underprice US exports destined for their affiliates based in low-tax jurisdictions and overprice US imports arriving from affiliates based in those same countries. They would have an incentive to characterize royalty income as affiliate profits. Many other examples could be cited. The United States and its closest trading partners—starting with Canada and Mexico and perhaps extending to EU member states—may eventually agree on formula apportionment of the corporate tax base for selected MNEs to mitigate transfer pricing abuse.²⁷ But so far, international agreement has been elusive, so we turn in the first instance to more immediate solutions.

For transactions among related parties, the tax law should be amended to require audited US firms to submit compelling evidence to rebut an IRS determination of the appropriate price of a transaction if the price asserted by the audited firm (by contrast with the price asserted by the IRS) would materially decrease the MNE group's total tax liability (US plus foreign). In other words, the tax liability would be calculated as if the transaction was priced according to the IRS view, in absence of contrary "compelling evidence" supplied by the taxpayer.²⁸ Because the corporate taxpayer has far better information about market terms and conditions than the IRS does, especially for intangible assets and differentiated products, this solution assigns a heavy burden of evidence to the audited firm, typically the corporate parent.

Of course the IRS should adequately staff its unit devoted to evaluating merchandise trade prices, royalties and fees, lease transactions, and salaries of highly paid US employees, such as executives, entertainers, and athletes.²⁹ The United States also should continue to work with its partners, particularly Canada, Mexico, and the European Union, to expand the pricing procedures developed in the last two decades within the framework of advance pricing agreements (APAs; see table 6.7).

Finally, as many observers (e.g., the 2007 Hamilton Project; see Clausen and Avi-Yonah 2007) have suggested, the United States should explore formula-apportionment approaches, at least for companies doing

27. Formula appointment would seem most appropriate for firms with large intra-MNE sales among affiliates located in Canada, Mexico, and the United States. Automobile companies might be a logical starting place.

28. Under current law, the burden of proof in a transfer pricing dispute already rests with the taxpayer. We would require, however, that the taxpayer discharge its burden by more than a "preponderance of evidence"; instead we would require the taxpayer to submit "compelling evidence." However, we would also require that the IRS determination not be "arbitrary or capricious," even if the taxpayer could not supply compelling evidence.

29. One possible rule of thumb is that, so long as the staff brings in \$100 million extra revenue for every \$20 million of additional administrative experts, it should be expanded.

Table 6.7 APA applications filed and executed, 1991–2005

Year	Unilateral	Bilateral	Multilateral	Total	Cumulative total
2000–2005					
Filed	205	322	0	527	928
Executed	170	206	3	379	610
1991–99					
Filed	n.a.	n.a.	n.a.	n.a.	401
Executed	112	114	5	231	231

APA = advance pricing agreement

n.a. = not available

Sources: Internal Revenue Service, Ann. 2004-26, 2004-15 Internal Revenue Bulletin 743; Ann. 2004-26, 2004-15 Internal Revenue Bulletin 743; Ann. 2003-19, 2003-1 Cumulative Bulletin 723; Ann. 2002-40, 2002-1 Cumulative Bulletin 747; Ann. 2001-32, 2001-1 Cumulative Bulletin 1113; Ann. 2000-35, 2000-1 Cumulative Bulletin 922; 2006-15 Internal Revenue Bulletin.

substantial business within North America and across the Atlantic. It must be acknowledged that formula apportionment is an old idea that so far has gained little practical traction. Among the US states, for example, it has been impossible to reach agreement on the factors and weights in the formula and which corporate subsidiaries should be included and which should be excluded from formula calculations. Nevertheless, with greater economic integration across jurisdictions, the arm's length pricing standard has become less satisfactory. Formula apportionment was commended in a recent study by the Hamilton Project (Clausing and Avi-Yonah 2007) and deserves to be explored within North America and across the Atlantics.

Allocation of Interest Expense

Under a territorial system, the interest expense allocation game simplifies dramatically. Because the United States would not tax the foreign dividends, interest, and earnings that a parent corporation received from its foreign subsidiaries or branches that earn active income, logically it would not allow a deduction for expenses attributable to that income.³⁰ Parent-company interest expense attributed to its holdings of debt and equity in its foreign affiliates would thus be disallowed as a deduction.³¹

30. This is a long-standing tax rule: Under section 265, deductions are disallowed for expenses attributable to exempt income.

31. The Canadian finance minister, Jim Flaherty, proposed a similar disallowance in the budget announced on March 19, 2007 (*North America Free Trade and Investment Report 17*, no. 6, March 31, 2007).

The only question is how much of the parent firm’s interest expense should be attributed to exempted foreign income. The key choice is whether interest expense should be allocated on the basis of income flows or asset positions. As debt is often incurred to support the acquisition of assets that do not produce income for several years, we propose that the allocation should be calculated on the basis of assets. The allocation fraction should be foreign net assets (assets minus liabilities owed to unrelated parties) relative to worldwide net assets. For administrative simplicity, we suggest using tax book values to calculate net assets.³² To minimize tax avoidance games, we would not allow interest expense to be “traced” to particular assets, for example, by secured mortgages.

Taxation of Interest Income

Under our territorial proposal, interest that an active affiliate pays to its US parent corporation would be exempt from US taxation. Two considerations motivate this exemption. First, the distinction between equity and debt—and hence between dividends or branch earnings and interest—is largely arbitrary when a parent corporation controls the affiliate. Second, our basic policy thrust is to exempt active affiliates from the US tax net.

We recognize that our proposed treatment of direct investment interest receipts starkly contrasts with our proposed treatment of portfolio interest receipts. Under our approach, on a residence basis, the United States would fully tax portfolio interest received from abroad. By contrast, direct investment interest received from abroad would be exempt from US taxation. We recognize that—unlike dividends from an affiliate, which are usually subject to taxation abroad as corporate earnings—interest payments from an affiliate are normally allowed as a business expense by foreign jurisdictions. In other words, interest payments are not part of the foreign corporate tax base, and they usually attract very low withholding taxes (zero, 5, or 10 percent). Thus, if affiliate interest payments to the US parent company are not taxed abroad, and if they are not taxed in the United States, they are essentially tax free. This seems anomalous, even bizarre.

The eventual solution is to reform the business tax system in a fundamental way, both in the United States and abroad, by disallowing deductions for interest payments made by a company to its controlling shareholder—in this example, the US parent firm. This change would eliminate the tax advantage of characterizing repatriated income as inter-

32. Conceptually, market values might provide a better basis for allocating interest expense than book values, but establishing market values can be highly contentious. Current law permits the use of market values, at the election of taxpayer. Allowing an election, of course, works to the disadvantage of the tax collector.

est expense rather than dividend payments. Moreover, the change would enable a reduction in the corporate tax rate because the corporate tax base would be enlarged. While this solution will not be enacted soon, we endorse zero taxation of intracorporate interest payments as an intermediate solution for two reasons. First, no real distinction exists between debt and equity in a controlled corporation. Second, zero taxation of direct investment interest payments will dramatically point toward basic reform.

Taxation of Royalties and Fees

Corresponding to the new approach to headquarters expense (RD&E plus G&A), all technology and reputation royalties, and all management fees paid from foreign sources for the use of know-how and services expensed in the United States, should be taxed by the United States under the residence principle. In our view, the country where the taxpayer resides should normally have the sole claim to tax the income generated by the activity.³³ As a companion measure, Internal Revenue Code (IRC) section 367(d) should be retained and strengthened as needed. In principle, section 367(d) prevents a US company from engaging in a tax-free or tax-preferred exchange of its own intangible assets for shares in a foreign corporate subsidiary. In practice, however, such transactions are common. Thus the IRS needs to beef up its surveillance of the prices charged in sales of intangible assets to related foreign companies; otherwise bargain sales of hard-to-value patents, copyrights, and trademarks to related companies based in low-tax jurisdictions will become commonplace.

In the context of these changes, the United States should seek international acceptance of the principle that royalties and fees paid to firms based in another country are properly deductible in the payor country and are free of withholding taxes. Within the OECD, the deduction of royalty and fee payments is standard practice, and withholding taxes on know-how income are already very low and could soon be abolished. However, because of the highly unequal two-way flow of royalties and fees between the United States and most developing countries, it may take time before these ideas of deductibility and zero withholding taxes are universally accepted.

We anticipate that US-based MNEs will argue that taxation of foreign-source royalties and fees on a residence basis will disadvantage RD&E and other headquarters activities carried on in the United States compared with

33. However, if the know-how was generated in the United States but the expense was incurred by a foreign corporation under a cost-sharing arrangement, the resulting royalties and fees should properly be taxed only by the foreign country under the residence principle. Conversely, if the know-how was generated abroad but the expense was incurred by a US corporation, the resulting royalties and fees should be taxed only by the United States.

similar activities carried out in a country that exempts foreign-source royalties and fees from domestic taxation. This is true. But how important is the argument in practice? The US law should be written to tax all foreign-source royalty and fee income conducted under the auspices of the US parent firm and its foreign affiliates if the RD&E is claimed as a deduction against US income. That way, the scope for tax avoidance by relocating activity will be reduced. Here is an example: If subsidiary S, located in Singapore, conducts RD&E that is claimed as a US deduction and earns royalties and fees from licensing the intangible property to India, that income should be taxed by the United States under the residence principle. As with any other transaction involving intangible assets, the question of the proper transfer price paid by India will still arise, and to deal with this question we would arm the IRS with the “compelling evidence” test mentioned earlier.

Legitimate concerns can still be raised about the effect of residence taxation on the location of RD&E facilities over the long term. After all, US-based MNEs would now incur a higher tax burden on their technology income earned worldwide than most MNEs based elsewhere. Accordingly, we suggest that, as a complementary measure, Congress should raise the current RD&E tax credit available under IRC Section 41.³⁴ Unlike preferential effective taxation of foreign royalties and fee income, an enhanced RD&E tax credit would be neutral between foreign and US locations when the firm chooses between sites for high-technology production.

Cost-Sharing Arrangements

As a general rule, RD&E expenses incurred by a US corporate taxpayer, whether incurred in the United States or abroad, can be claimed as a deduction against corporate income taxable by the United States.³⁵ The same principle applies to bona fide cost-sharing arrangements under the procedures for APAs.³⁶ A cost-sharing agreement for RD&E enables each participant to enjoy exclusive rights to the use of the technology generated by the venture in designated markets and applications. Costs shared

34. Currently the RD&E credit amounts to about \$9.3 billion annually, compared with \$223 billion of total private RD&E expenditure, which includes RD&E expenditures both within the United States and by foreign affiliates of US parents outside the United States in 2004. Bills proposed in 2007 would liberalize the rules, increasing the credit to as much as \$15 billion annually (*Wall Street Journal*, May 30, 2007).

35. The same rule applies to G&A expense. We recommend that, after five years, the Treasury should evaluate the balance between return flows of foreign-source royalties and fees, as well as deductions claimed for RD&E and G&A expense attributed to affiliates.

36. Appendix A9 summarizes the procedures. The “investor model” proposed in the regulations for preexisting technology has been criticized for giving US-based MNEs an incentive to move their RD&E activities offshore.

by firms based in different countries are normally allocated as business deductions among those countries according to the agreement, no matter where the RD&E performed.

In our view, current law should be amended so that the United States only permits the expensing of RD&E costs, including cost-sharing contracts, incurred abroad on a reciprocal basis. This would require an amendment to IRC Section 174.³⁷ In other words, the partner country should also permit its firms to claim a deduction for RD&E costs incurred in the United States, including cost-sharing arrangements. Similar principles should apply to overseas performance and cost-sharing arrangements for G&A.

Executives, Entertainers, and Athletes

Among many possible abuse schemes, highly paid taxpayers—executives, entertainers, and athletes—are tempted to set up shell “management” corporations overseas to “employ” themselves. Customers who wish to engage the taxpayer’s services then enter into a contract with the overseas company. The taxpayer might direct the company to make tax-free “business expenditures” for his benefit, even expenses that bear little relationship to generating corporate income. Although the company might pay a salary taxed in the United States to the employee/owner, most of the shell corporation’s “profit”—essentially remuneration of the valued employee—can remain outside the US tax net. When it is time to pay US taxes, the taxpayer/owner would try to claim that the management corporation is an “active” business firm, not subject to current taxation under the present US system or any taxation under our proposed territorial system.

Schemes with a similar flavor are conceivable under almost any tax system. As an example, lawyers for Robert Wood Johnson IV—heir to the Johnson & Johnson fortune and owner of the New York Jets—devised a series of transactions on the Isle of Man that reportedly cost the US Treasury \$300 million.³⁸ Telecom entrepreneur Walter Anderson likewise admitted to evading about \$200 million in US taxes through a scheme that involved establishing Caribbean corporations to hide his income from US authorities.³⁹ In our view, the best answer to these and similar abuses

37. We recommend a similar amendment for the RD&E tax credit under Section 41.

38. Johnson told a Senate panel that his lawyers informed him the transaction “was consistent with the Tax Code.” However, when the IRS challenged his accounting, which involved two overseas corporations with 2 pounds sterling of paid-in capital generating \$2 billion in capital losses, Johnson settled with the IRS and agreed to pay all back taxes plus interest (“Tax Shelters Saved Billionaires a Bundle,” *Washington Post*, August 1, 2006, A4).

39. See CBS News, “Telecom Founder Pleads Guilty To Fraud,” September 8, 2006.

lies in a strict definition of active business firms, coupled with aggressive enforcement of current taxation of all forms of portfolio income, to defeat attempts to escape the residence principle for taxing individuals and their wealth.

Discriminatory Taxation

US policy should attempt to ensure that foreign tax systems do not discriminate against US taxpayers. To that end, the United States should continue its strategy of using bilateral tax treaties to reciprocally reduce the level of withholding taxes faced by both US MNEs doing business abroad and foreign MNEs doing business in the United States. This strategy has already succeeded in driving withholding taxes down significantly but has not eliminated them (see table 6.8).

Although withholding taxes have been eliminated with respect to interest, royalties, and service fees in most US treaties, such taxes still put US MNEs at a competitive disadvantage regarding dividends from controlled foreign corporations (CFCs). While the United States has eliminated withholding tax on direct investment dividends in several recent tax treaties (Australia, Belgium, Germany, Japan, Mexico, the Netherlands, Sweden, and the United Kingdom), it is lagging behind EU member states and many other developed countries. The United States continues to apply withholding taxes to direct investment dividend payments in most of its tax treaties, and its treaty partners do likewise.

Dividend withholding taxes put US MNEs at a significant competitive disadvantage vis-à-vis their EU-based multinational competitors. More than 15 years ago, the European Union adopted a directive that generally eliminated withholding taxes on cross-border direct investment dividend payments between member states, the Directive on Parent Companies and subsidiaries (90/435/CEE). As the directive requires that the firms involved must be incorporated in EU member states, the European Union continues to discriminate against dividend payments from EU firms to US firms.⁴⁰

To end tax discrimination, the United States should offer a so-called “zero-zero” option: The United States would drop its own withholding rates on dividend payments to zero for payments to partners that do like-

40. Until the introduction of section 954(c)(6) of the IRC (see appendix A3), the US system itself discriminated against US firms operating in Europe, as they were subject to subpart F taxation when dividends cross internal European borders. Some legislative proposals addressed this problem by proposing to treat the European Union as one country for purposes of subpart F (see, e.g., HR 4151, 107th Congress). Section 954(c)(6) achieved the same result in a different manner; however this provision sunsets in 2009 and, it is not clear whether Congress will extend the section beyond 2008.

Table 6.8 Withholding rates applied by the United States, 1990 and 2005 (percent)

Country	Dividends							
	Controlled foreign corporations ^a		Portfolio		Interest		Royalties	
	1990	2005	1990	2005	1990	2005	1990	2005
US statutory rate ^b	30	30	30	30	0/30 ^c	0/30 ^c	30	30
US treaty with ^d								
Canada (1984)	10	10	15	15	15	15	10	10
Japan (2004)	10	0/5 ^e	15	10	10	0	10	0
Germany (1991)	10	5 ^f	15	15	0	0	0	0
Netherlands (2004)	5	0/5 ^g	15	15	0	0	0	0
United Kingdom (2003)	5	0/5 ^g	15	15	0	0	0	0

a. Controlled foreign corporations (CFCs) are defined differently, in terms of their threshold share of ownership, in treaties with different countries.

b. Treaty rates are reciprocal: The same withholding rate is applied by the United States to a given type of income as is applied by the foreign country.

c. Portfolio interest from US debt obligations issued after July 18, 1984 and interest paid by US banks and insurance companies are exempt.

d. Year in parentheses represents the year in which the most recent treaty or protocol modifying the treaty entered into force.

e. The zero percent withholding tax applies if the parent company owns more than 50 percent of the CFC voting stock; otherwise the 5 percent withholding rate applies if the parent company holds at least 10 percent of the CFC voting stock.

f. The 5 percent withholding tax applies if the parent company holds at least 10 percent of the CFC voting shares.

g. The zero percent withholding tax applies if the parent company owns more than 80 percent of the CFC voting shares; otherwise the 5 percent withholding rate applies if the parent company owns at least 10 percent of the CFC voting shares.

Sources: PricewaterhouseCoopers (1990); CCH, Tax Treaties, 2005, Volumes I-IV.

wise for payments to the United States. Zero-zero withholding is particularly important as a tax goal with Japan, Canada, and members of the European Union (see box 6.1).

Tax Treaty Policy

Much of our reform package can be implemented unilaterally through appropriate legislation enacted by Congress, assuming that domestic political hurdles can be overcome. However, important components can

Box 6.1 Zero-Zero taxation

Recent US tax negotiations with Japan, the United Kingdom, and the Netherlands indicate that the United States is moving toward a zero-zero approach to withholding taxes. This approach entails a complete exemption from withholding tax on dividends paid to qualifying pension funds and, under certain circumstances, on dividends that affiliates pay to their parent corporations. It also entails a complete exemption from withholding tax on royalties for the right to use certain enumerated assets, such as patents, trademarks, and certain copyrights; and a complete exemption for interest paid to certain recipients, such as banks, insurance companies, and qualifying pension funds.

Revenue considerations—rather than economic considerations—might trigger the opposition of developing countries to a similar zero-zero system. Some developing countries still collect substantial amounts of revenue from inward foreign direct investment and technology imports, and these countries could be willing to phase in lower withholding rates over an extended period of time. A few enlightened countries may, however, follow the example of Mexico, which agreed to introduce a zero withholding tax for dividends as a means of attracting corporate investment (see the Second Additional Protocol that Modifies the Convention between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, available at www.treas.gov).

The US Senate Committee on Foreign Relations noted, in the context of approving the Mexican Protocol, that the Treasury Department should include similar provisions in future tax treaties or protocols, but only on a case-by-case basis (see Senate Foreign Relations Committee Report, Executive Report 108-4, 2003 TNT 55-17, 108th Congress, March 21, 2003).

In light of our recommendations in chapter 4 for a back-up withholding tax to ensure proper reporting of portfolio income to the residence country, we think the zero-zero approach should be coupled with comprehensive exchange of information systems, especially if extended to low-tax countries that are often conduits for tax evasion.

only be put in place with the cooperation of the European Union, Japan, Canada, and other economic partners. In particular, the principle of residence-only taxation for portfolio income and the determination of appropriate transfer prices both require tax cooperation among the major countries.

We do not rely entirely on sweet reason to accomplish these objectives. Instead, our reform package contains sticks as well as car-

rots to encourage tax cooperation. Without cooperation, for example, the United States would maintain its existing statutory withholding rates. On the other hand, in the context of a satisfactory treaty, the United States could allow other countries to limit the deduction for interest paid by a foreign affiliate to its US parent (and reciprocal treatment could be applied to foreign-owned affiliates located in the United States).

The traditional vehicle for tax cooperation is the bilateral income tax treaty. The United States currently has in force 63 comprehensive bilateral income tax treaties, 24 of them with member states of the European Union.⁴¹ Traditionally the four main purposes of an income tax treaty have been to establish a minimum threshold before business activity in a foreign country becomes subject to local income taxation (the permanent establishment concept); to avoid double taxation; to reduce discriminatory taxation; and to deter tax evasion.⁴²

To facilitate future tax treaty negotiations, especially in deterring tax evasion on portfolio income, the United States should build on moves toward regional integration already under way. The starting place is Europe: The United States should seek a single tax treaty with the entire European Union, at least with respect to portfolio income.⁴³ Cooperative reforms would prove difficult if the United States followed its past practice of negotiating separate treaties with each of the 25 EU member states, but significant progress toward deterring tax evasion on portfolio income can be accomplished if the United States and the European Union reach a common accord.

41. The United States currently has a tax treaty with all of the members of the European Union except Malta, which the United States perceives as a tax haven country.

42. The rapid growth of cross-border e-commerce raises important tax issues, especially in determining the source of income. Tax treaties often help to resolve the conflicts in source classification of income. For details, see appendix E.

43. The so-called Open Skies cases decided by the European Court of Justice on November 5, 2002 (*Commission v Belgium C-471/98*, *Commission v Denmark C-467*, *Commission v Sweden C-468*, *Commission v Finland C-469*, *Commission v Luxembourg C-472*, *Commission v Austria C-475*, *Commission v FRG C-477*) can be read as a harbinger of a new approach to tax relations between the United States and the European Union. In the Open Skies cases, the court determined that eight bilateral air transport agreements between individual EU members and the United States infringed EU treaty obligations that prohibited restrictions on the freedom of establishment among member states. Based on this precedent, if the court were called upon to rule on the limitation on benefits provisions in bilateral tax treaties between the United States and several EU members, these limitations might likewise be found to be in conflict with EU treaty obligations. Nevertheless, in December 2004, Barbara Angus, US Treasury international tax counsel, stated that as long as European countries had different tax systems, the United States would continue to negotiate tax relations with individual EU member states. See Sheppard (2004).

Revenue Implications

Revenue considerations are often paramount in shaping tax legislation. Corporate taxpayers are generally far more concerned about the short-term bottom-line impact of tax measures than long-run systemic effects. The same myopia has long afflicted the Treasury and Congress. Hence, it is worth examining the revenue estimates associated with our proposals, for both foreign income accruing to US MNEs and US affiliates of foreign MNEs, and US income accruing to foreign MNEs and foreign affiliates of US MNEs. We offer our calculations as rough guideposts. Unlike Treasury and Joint Tax Committee staff, we do not have access to corporate tax returns; hence we rely on published aggregates from IRS and BEA sources.

Revenue on Outward US Investment

The place to start is with foreign income and ultimate US tax collections in 2002, the most recent IRS figures available (table 6.5). In that year, gross foreign “general limitation income,” a category that corresponds closely to “active” income, amounted to \$226 billion. This figure includes dividends repatriated (or deemed repatriated) from foreign affiliates (plus the gross-up for underlying foreign corporate taxes), together with foreign-source export profits, royalties, and fees. This figure, however, does not include foreign affiliate earnings unless they are repatriated to US corporate taxpayers either as dividends, interest, royalties, or fees.⁴⁴

Expenses incurred by US corporate taxpayers that were allocated as deductions against repatriated “general limitation income” amounted to \$112 billion, leaving \$114 billion as US taxable income in 2002.⁴⁵ After the estimated foreign tax credit of \$33 billion, US tax collections amounted to an estimated \$7 billion, about 3 percent of all gross “general limitation” or “active” income repatriated to the United States. Most of the taxes collected on general limitation income correspond to foreign-source royalties, fees, and export profits that were not shielded from US corporate taxes by excess foreign tax credits, those resulting from foreign corporate taxes that are “deemed paid” by the US parent firm, which received dividends from its affiliates abroad.

44. Corporate earnings from active US direct investment not repatriated in 2002 (based on Bureau of Economic Analysis statistics) were approximately \$79 billion, which includes a current cost adjustment for inventory valuation. The amount of reinvested earnings by active firms without the current-cost adjustment was approximately \$59 billion. See Bureau of Economic Analysis, US International Transactions Accounts Data, Table 6a, December 2006 (available at www.bea.gov).

45. US deductions allocated to foreign-source income are primarily interest expenses, RD&E, and G&A expenses.

In 2002 gross foreign “financial services income” repatriated to the United States—a category that includes a mixture of “active” and “passive” income—amounted to \$85 billion. We estimate that “financial services income” not repatriated in 2002 was about \$7 billion.⁴⁶ Allocated deductions (mainly interest expense and insurance claims) against repatriated income were \$64 billion, leaving \$21 billion as US taxable income. After the estimated foreign tax credit of \$7 billion, about \$1 billion of US tax was collected, suggesting an effective US rate of about 1 percent on gross repatriated financial services income.

In 2002 gross foreign income of a purely passive nature, including subpart F income, amounted to \$20 billion. As a first approximation, purely passive income as currently defined in the IRC is either repatriated or deemed repatriated under existing US tax law. US deductions allocated to this income, mainly as interest expenses, were \$9 billion; US taxable income was \$11 billion; and the foreign tax credit was \$2.5 billion. The result is that about \$1.5 billion US tax was collected, an effective US rate of about 8 percent.

All told then, we estimate that US taxes collected on after-foreign tax US income under the current system were around \$9 billion in 2002, a little under 3 percent of repatriated or deemed repatriated foreign-source income.⁴⁷

As the next step in examining the revenue consequences of our recommended territorial system, table 6.9 repeats the exercise in table 6.5. Unlike the actual tax collection experience in 2002, our hypothetical calculations start with total earnings, not repatriated income flows. To estimate total earnings, whether or not they are repatriated, we account for \$85 billion of retained earnings plus \$34 billion for the estimated gross-up for the underlying foreign corporate tax on retained earnings. This addition of retained earnings and underlying foreign taxes increases total US foreign income by about \$120 billion to a pre-foreign tax total of \$450 billion.⁴⁸ In addition, we add a special line for US interest expense that would be disallowed as a US business deduction under our recommendation. This interest expense is disallowed because it is attributed to active income, which is exempt from US taxation under the territorial system. Business expenses that are attributed to exempt income cannot

46. The figure of \$7 billion does not include any current-cost adjustment for inventories, as inventory is not a major item for financial source firms.

47. By comparison, Grubert (2005) estimated that US tax collected on foreign-source income was \$12.7 billion in 2000.

48. According to BEA data, in 2002 total retained earnings after foreign corporate tax were \$85.3 billion. \$78.8 billion of this was retained by firms in the general limitation category; \$6.5 billion was retained by the financial sector. For table 6.8, we estimated foreign taxes of \$31.9 billion in the general limitation category and \$2.3 billion in the financial services sector.

Table 6.9 Hypothetical US income from foreign sources, foreign tax credits, and US tax revenue under territorial system, 2002

Category/type	Foreign gross income flows before foreign taxes paid	Foreign taxes deemed paid or withheld at source		Recommended tax rates under territorial system	Tentative US tax liability	Estimated foreign tax credit claimed	Estimated US tax revenue
		Rate	Amount				
Total US foreign income (before foreign taxes) whether repatriated or retained	450.4	16.8	75.6		29.4	5.1	24.3
Corporate earnings before foreign taxes	198.1	29.3	58.0		0.0	0.0	0.0
Passive income in other passive income category	9.7	19.6	1.9		4.0	2.5	1.5
Interest ^a	44.5	7.4	3.3		3.0	0.1	2.9
Rents, royalties, and license fees	57.3	4.0	2.3		19.6	2.3	17.3
Services income ^{a,i}	17.1	13.5	2.3		0.0	0.0	0.0
Other income (including export profits)	123.7	6.3	7.8		2.8	0.2	2.6
<i>Addenda:</i> US interest expense attributed to exempt foreign income and disallowed ^b	30.6				10.7	0.0	10.7
General limitation income (active income) whether repatriated or retained	336.3	19.1	64.2		18.1	2.3	15.8

Corporate earnings before foreign taxes	178.0 ^c	28.5	52.3 ^d	0.0	0.0	0.0	0.0
Interest ^a	5.7	1.8	0.8	0.0	0.0	0.0	0.0
Rents, royalties, and license fees	51.6	4.5	2.3	35.0	18.1	2.3	15.8
Services income ^{a,i}	15.0	13.3	2.0	0.0	0.0	0.0	0.0
Other income (including export profits)	86.0	7.9	6.8	0.0	0.0	0.0	0.0
<i>Addenda: US interest expense attributed to exempt foreign income and disallowed^b</i>	11.4			35.0	4.0	0.0	4.0
Financial services income (active and passive)	93.8	9.6	9.0		7.4	0.3	7.1
Corporate earnings before foreign taxes	20.1 ^e	29.1	5.7 ^f	0.0	0.0	0.0	0.0
Interest ^{a,g}							
Active income	26.2	6.5	1.7	0.0	0.0	0.0	0.0
Passive income	8.7	5.7	0.5	35.0	3.0	0.1	2.9
Rents, royalties, and license fees ^h	4.2	0.0	0.0	35.0	1.5	0.0	1.5
Services income ^{a,i}	2.0	15.0	0.3	0.0	0.0	0.0	0.0
Other income ^g							
Active income	24.5	0.0	0.6	0.0	0.0	0.0	0.0
Passive income	8.1	2.5	0.2	35.0	2.8	0.2	2.6
<i>Addenda: US interest expense attributed to exempt foreign income and disallowed^b</i>	19.2			35.0	6.7	0.0	6.7

Table 6.9 Hypothetical US income from foreign sources, foreign tax credits, and US tax revenue under territorial system, 2002 (continued)

Category/type	Foreign gross income flows before foreign taxes paid	Foreign taxes deemed paid or withheld at source		Recommended tax rates under territorial system	Tentative US tax liability	Estimated foreign tax credit claimed	Estimated US tax revenue
		Rate	Amount				
Other passive income before allocated US deductions ^l	20.3	12.3	2.4	35.0	4.0	2.5 ^k	1.5 ^k
Passive dividends	9.7	19.6	1.9				
Passive interest, rents, royalties, license fees, services, and other passive foreign incomes	10.6	11.3	0.5				

a. Foreign taxes paid in 2002 on branch income are attributed to interest and services income, prorated according to gross income flows.

b. In 2002 total allocated US deductions were \$185 billion (table 7.8). We assume that these deductions were allocated to active income. Of this amount, \$32.7 billion was allocated interest expense. Other than interest expense, US deductions (research, development, and experimentation and G&A) are assumed not to be allocated to exempt foreign-source income under the territorial system. US interest expense attributed to exempt foreign income could not be deducted as a business expense for US corporate tax purposes. Hence, under a static calculation, US tax revenue would rise. In practice, however, US-based multinational enterprises would rearrange their balance sheets to reduce the amount of nondeductible interest expense. The estimated tax revenue gains from disallowed interest expense are not included in the totals for estimated US tax revenue on foreign-source income.

c. Reinvested earnings of \$110.7 billion (including a gross-up for estimated foreign corporate taxes) are included in this figure.

d. This figure includes \$31.9 billion of estimated foreign corporate taxes on retained earnings.

e. Foreign corporate earnings in the financial services sector are assumed to be active income. Reinvested earnings of \$8.8 billion (including a gross-up for estimated foreign corporate taxes) are included in this figure.

f. This figure includes \$2.3 billion of estimated foreign corporate taxes on retained earnings.

g. Assuming that 75 percent of financial services interest income and other income represents active income and 25 percent represents passive income. This division is highly arbitrary.

h. All rents, royalties, and license fees are taxed under the residence principle.

i. All services income is assumed to be active income, even though some passive fee and leasing income are included in this category.

j. Total US allocated deductions for this category of income were \$9 billion, leaving \$11.3 billion as taxable income.

k. Foreign tax credit claimed and US tax revenue are both estimated.

Sources: Internal Revenue Service, Statistics of Income, Fall 2005, statistical tables for US corporate returns with a foreign tax credit, available at www.irs.gov (accessed January 8, 2007); Bureau of Economic Analysis, US International Transactions Accounts Data, table 6a (December 2006).

logically be claimed as a US deduction, a principle stated in IRC section 265. Disallowance of the attributed interest expense implies additional US revenue—we estimate an additional \$10.7 billion in 2002.

Starting with pretax foreign gross income, whether or not it is repatriated, table 6.9 walks through the tax consequences of our recommendations for “active” and “passive” income, distinguishing between types of income within these broad categories. Before calling out some of the details, we start with the headline. Perhaps most surprising is that table 6.9 suggests that US tax revenue on foreign-source income would amount to approximately \$24 billion under a territorial system, more than twice the actual tax collections we calculated under the current system in 2002 (table 6.5). In addition, the United States might have collected a further \$11 billion from disallowed interest expense. This estimate of potential revenue may well be exaggerated because, as a static calculation, it does not account for evasive actions by US corporate taxpayers. However, the calculations support other experts’ expectations that a territorial system would actually raise revenue on foreign-source income.

Out of \$24 billion of estimated tax revenue, we calculate that \$17 billion is raised from foreign rents, royalties, and license fees, and \$7.0 billion comes from purely passive income. In other words, under the proposed territorial system, US tax revenues are essentially derived from two types of foreign-source income: royalties and fees and passive income. The reinvested earnings of active corporations do not contribute to higher US tax revenue.

Most of the new US tax revenue collected from royalties and fees results from disallowing the cross crediting of foreign corporate taxes. Because of this change, US-based MNEs would no longer have a tax incentive to produce high-technology goods and services abroad rather than in the United States. We acknowledge that this change would deplete the flow of income that currently supports US RD&E activity. Hence we strongly recommend, as a linked change, that Congress should increase the RD&E credit under IRC section 41, or the RD&E deduction under IRC section 174.

