

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a light blue color with darker blue outlines for continents. The hourglass is centered on the page.

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

Donald J. Marples, Government and Finance Division

May 21, 2008

Abstract. One of the chief manifestations of the increased openness of the U.S. economy is an increase in U.S. investment abroad. U.S.-based multinational firms are increasing their overseas operations and U.S. investors are increasing the foreign assets in their portfolios. This report analyzes how the current U.S. tax system applies to foreign investment undertaken by U.S. firms abroad, and how that application was changed by recent legislation. It also assesses the impact of the tax system and legislation, and concludes by discussing a variety of issues in international taxation that Congress may face in 2008 and beyond. It begins with a brief examination of the data on international investment.

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CRS Report for Congress

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

Updated May 21, 2008

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Prepared for Members and
Committees of Congress

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

Summary

Investment abroad by U.S. individuals and firms is substantial and growing — an important aspect of the increased integration of the U.S. economy with the rest of the world. At the end of 2006, the overall stock of private U.S. investment abroad was 38.4% of the total U.S. stock of private capital; the proportion has more than doubled over the past two decades. Because investment outflows have grown, it is not surprising that U.S. taxation of overseas investment has been and is likely to remain a prominent issue before Congress. First, because investment abroad is an increasingly important part of the economy, the effects of taxation on foreign investment are potentially more important. Second, the increased mobility of capital has changed the environment in which taxes apply; some have suggested that capital's mobility may call for a change in U.S. tax policy.

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

Whether these various effects are considered beneficial depends, in part, on the perspective a policymaker takes. Traditional economic theory suggests that a tax policy that promotes neutrality between investment at home and abroad best promotes world economic welfare. Economic theory also indicates, however, that U.S. economic welfare is maximized when overseas investment is to a degree discouraged. Different components of the U.S. tax system are consistent with different perspectives; which perspective the U.S. tax system best exemplifies is not clear.

The varied effects of the U.S. tax system suggest an ambivalence towards overseas investment on the part of policymakers and the public. In the 110th Congress, H.R. 3970 proposes to implement changes that vary in their likely effect on foreign investment — echoing the underlying tax system. This implied ambivalence — along with foreign investment's growing importance — suggests that debate over U.S. international taxation will continue in Congress in 2008 and beyond. Some possible issues include the place of international taxation in a possible movement towards fundamental tax reform; and whether the United States should move towards a “territorial” tax system or — alternatively — adopt provisions designed to either promote tax neutrality or limit “offshore outsourcing.”

This report was originally written by David L. Brumbaugh, Specialist in Public Finance, who has retired from CRS. It will be updated as legislative events occur.

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

One of the chief manifestations of the increased openness of the U.S. economy is an increase in U.S. investment abroad. U.S.-based multinational firms are increasing their overseas operations and U.S. investors are increasing the foreign assets in their portfolios. This report analyzes how the current U.S. tax system applies to foreign investment undertaken by U.S. firms abroad, and how that application was changed by recent legislation. It also assesses the impact of the tax system and legislation, and concludes by discussing a variety of issues in international taxation that Congress may face in 2008 and beyond. It begins with a brief examination of the data on international investment.

The United States in the World Economy

The most basic economic data clearly show that the U.S. economy is increasingly involved in the world economy. In the language of economics, the U.S. economy is growing more “open.” For example, the data show that the total volume of trade in goods and services, that is, exports plus imports, has increased substantially and steadily over the past 30 years. In 1977, exports plus imports were 16.8% of U.S. gross domestic product (GDP); by 2007 trade was a full 28.8% of GDP.¹

But the focus here is on capital investment, and if trade has increased substantially, investment has grown dramatically. Rough estimates indicate that in 1976, the stock of U.S. private assets abroad was 6.7% of the total U.S. privately-owned capital stock; by year end 2006, assets abroad were 38.4% of the total U.S. private capital stock. In 1976, the stock of foreign private assets in the United States was 3.7% of the U.S. capital stock; at year end 2006 it was 38.8% of private U.S. capital.²

¹ Data on trade is from Table 4.1. Foreign Transactions in the National Income and Product Accounts, Bureau of Economic Analysis, downloaded on February 29, 2008, and data on Gross Domestic Product is from Table 1.1.5 Gross Domestic Product, Bureau of Economic Analysis, downloaded on February 29, 2008.

² The source for data on U.S. assets abroad and foreign assets is in “Table 2: International Investment Position of the United States at Yearend, 1976-2006,” Bureau of Economic Analysis, downloaded on February 29, 2008. Data on the U.S. capital stock are from “Table 1.1. Current-Cost Net Stock of Fixed Assets and Consumer Durable Goods,” Paul R. Lally, “Fixed Assets and Consumer Durable Goods for 1925-2001,” *Survey of Current Business*, vol. 81, Sept. 2002, pp. 23-37, and David B. Wasshausen, “Fixed Assets and Consumer
(continued...)

It is informative to examine the components of outbound investment. Traditionally, economists have identified two types of overseas investment: portfolio investment and direct investment. With portfolio investment, the underlying assets are not actively managed by the investor; direct investment entails the active management of overseas assets and operations by the investor. Portfolio investment can be thought of as a U.S. person or firm who has foreign stocks, bonds, or other assets in his investment portfolio; direct investment can be thought of as the overseas business operations of a U.S. firm. The data suggest that the rapid growth in U.S. assets abroad has consisted almost entirely of portfolio investment rather than direct investment in overseas business operations. At year-end 1976, portfolio investment abroad was 2.7% of the total U.S. capital stock; at the end of 2006, it was 29.4% of the total stock. In contrast, foreign direct investment was 4.1% of the total in 1976 and 9% at the end of 2006.

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

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

² (...continued)

Durable Goods for 1997-2006," *Survey of Current Business*, vol 87, Sept. 2007, pp 31-32. The fixed assets data were adjusted to include estimated stocks of inventory and intangible capital.

³ Data on receipts from foreign investment are from Douglas B. Weinberg and Kelly K. Pierce, "U.S. International Transactions, Third Quarter 2007," *Survey of Current Business*, vol. 88, Jan. 2008, p. 22. U.S. capital income data are from "BEA Current and Historical Data," *Survey of Current Business*, vol. 84, Nov. 2004, p. D-16.

How Taxes Affect International Investment

This section of the report sets forth the basic economic analysis of how taxes in the abstract affect international investment. First, economic theory stipulates that a firm's fundamental goal is to maximize its profits — after taxes. When a firm considers where to employ its investment, it implicitly weighs the relative rate of return on investment in its various locations — again, after taxes. Taxes can therefore pose an incentive for firms to invest overseas if the tax burden abroad is lower than the burden on identical investment in the United States. Alternatively, taxes can pose a disincentive towards foreign investment compared to investment in the domestic economy if taxes are relatively high in overseas locations. Or, taxes can be “neutral” towards the investment decision; if the tax burden is the same on foreign investment as on identical domestic projects, then taxes have no impact on where firms invest. The implication of this framework is clear: if U.S. and foreign tax systems as a whole were to favor either location over the other, then U.S. investment in the favored location would be higher than would otherwise occur. The discussion of the impact of particular features of the U.S. system is deferred until the next section, but note here that the overall thrust of the system is mixed in its incentive effects, with no clear net impact.

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

Investment and the Distribution of Income

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

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

Along with their impact on how income is distributed, taxes on capital flows have broad effects on economic efficiency or how much income is available for

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

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

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

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

Even if U.S. labor were not directly disadvantaged by the shifting of investment abroad, neutral taxation would still not maximize U.S. economic welfare in cases where foreign host governments impose their own tax on U.S. investors. This result occurs because the benefit to the United States of an additional unit of overseas investment is the return on that investment, less foreign taxes. The return on that same investment made in the United States, however, is the return on the investment plus any tax collected by the United States.

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

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

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

Another argument supporting CIN holds that overseas investment produces a higher return for research and certain other activities multinationals undertake; these activities carry with them "external" benefits to the economy as a whole that make the return to research greater than the private return to the firm conducting the research.⁵ While it can be argued that external benefits from research suggest a subsidy is warranted, such a subsidy seems likely to be more accurately targeted if it were to apply only to research rather than foreign income. Further, the tax code already provides such a subsidy in the form of a tax credit and deductions for research.

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

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

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

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

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

Basic Jurisdictional Principles and the Foreign Tax Credit

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

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

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

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

investment has first claim to tax that investment and first claim on the tax revenue it potentially produces.

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

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

The Foreign Tax Credit Limitation and Cross-Crediting

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

Suppose, then, that a firm has no existing overseas investment and is contemplating a new project in a country with a high tax rate — say, a 50% foreign tax rate compared to the 35% U.S. tax rate. In this case, foreign tax credits could be counted on to eliminate all 35 percentage points of U.S. tax on the new investment's income, but the remaining foreign tax — 50% minus 35%, or 15% of the investment's income — would not be creditable. The total tax on the foreign investment would consist of only the 50% foreign tax, but would be high relative to taxes on identical U.S. investment and would pose a disincentive to invest in the high-tax country.

As described above, NN is a policy perspective that recommends a disincentive to invest abroad, and so, in a sense, the limitation on the foreign tax credit introduces an element of NN into the U.S. system. The actual incentive situation, however, is

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

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

The ability of firms to cross-credit foreign taxes has been restricted and relaxed at various times by the U.S. tax code in various ways.

Deferral

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

Deferral works as follows: under the U.S. residence-based tax regime, corporations chartered in the United States are taxed on their foreign as well as domestic income. In contrast, the United States generally taxes foreign-chartered corporations only on income earned in the United States. Thus, where a U.S. parent firm invests abroad through a separately incorporated subsidiary firm chartered in a foreign country, U.S. taxes do not apply to its foreign income as long as the income is reinvested abroad. U.S. taxes apply only when the income is repatriated to the U.S. parent firm as income or other income. U.S. taxes are, in other words, deferred or postponed. Because of discounting, taxes paid in the future do not matter as much to a firm as an identical amount paid in the present. Because of discounting, deferral results in a lower overall tax burden for foreign investment compared to domestic investment in cases where foreign taxes are relatively low. The low tax burden under deferral occurs regardless of whether a firm has excess credits available for cross crediting.

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

Subpart F's Restriction of Deferral

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

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

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

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

The System's Overall Mix of Incentives

The framework described presents a patchwork of effects on relative tax burdens and a mix of incentives, disincentives, and neutrality. The tax system's overall, average impact on investment is not presented; the tax system is not consistent with any one of the three policy perspectives of CEN, NN, and CIN. The following chart, however, is useful in identifying the circumstances in which each of the various incentive effects occur. As shown in the table, whether new overseas investment faces an incentive, a disincentive, or neutrality depends on whether the

prospective investment is in a country with relatively high or low tax rates, and on whether a firm has existing investment that has generated excess credits.

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

Investor's foreign tax credit position	Investment in high-tax countries	Investment in low-tax countries
No Previous Foreign Investment	Disincentive	Neutrality (If deferral is not used) Incentive (if deferral is used)
Excess Credits	Disincentive	Incentive
Deficit of Credits	Neutrality	Neutrality (if deferral is not used) Incentive (if deferral is used)

Domestic Provisions and International Investment

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

Notable among the incentives for domestic investment are the research and development (R&D) tax credit and two separate tax incentives for exporting.⁸ The R&D credit provides a tax benefit for firms that increase their qualified research expenditures; “qualified research,” however, explicitly excludes research conducted abroad. The two export incentives are the “inventory source rule” and the extraterritorial exemption rules for exporters; they provide an incentive for domestic investment because exports — by definition — cannot be produced abroad. The inventory source rule provides an export incentive by allowing firms to allocate part of their export income abroad for foreign tax credit limitation purposes; the

⁸ The R&D tax credit expired on Dec. 31, 2007, but is one of a number of tax expenditures commonly referred to as an “extender.” Like the R&E tax credit, extenders were originally enacted with expiration dates that have subsequently been extended, in some cases numerous times. For additional information on extenders, see CRS Report RL32367, *Certain Temporary Tax Provisions (“Extenders”) Expired in 2007*, by Pamela J. Jackson and Jennifer Teefy.

consequence of the allocation is potentially an effective exemption for a part of export income.

Possible Issues in 2008 and Beyond

What does this context predict as international tax issues that may arise in 2008? In abstract, general terms, the hybrid nature of the U.S. system suggests debate over the appropriate course for U.S. policy may continue through 2008. In more specific terms, a number of possible issues suggest themselves, and they are discussed in the following sections.

Fundamental Tax Reform and International Taxation

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

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

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

A shift to a consumption tax would likely alter the comparative tax burden on domestic compared to foreign investment. Under a consumption tax, the return on new domestic investment would be exempt from U.S. tax, while under the most prominent proposals made in past years, foreign-source income would be outside the U.S. tax jurisdiction. As a result, new U.S. investments would face a relatively low tax burden compared to investment abroad, which would continue to face corporate

taxes imposed by foreign governments. Thus — except in jurisdictions with no taxes of their own — U.S. firms would face a tax incentive to invest in the United States rather than abroad.⁹ As a cautionary note, however, some analyses have concluded that shifting to a consumption tax may reduce domestic real interest rates even if such a tax were revenue neutral. In isolation, this would have an effect in the opposite direction of the direct impact of relative domestic and foreign tax burdens.

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

Territorial Taxation

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

A territorial tax would be consistent with the principle of capital import neutrality described above. Multinational firms and investors have frequently supported territorial taxation, or at least a movement in that direction, if not for reasons that explicitly have CIN in mind, then to promote U.S. “competitiveness.” Some have argued, for example, that as the U.S. economy becomes increasingly open and U.S. firms increasingly compete in the global marketplace, the tax system should be modified to promote U.S. firms’ competitiveness. While the net, overall thrust of the 2004 AJCA on incentives towards overseas investment was mixed, its contraction of Subpart F and consolidation of foreign tax credit baskets can nonetheless be viewed as incremental movements in the direction of territoriality. It is thus possible that the 110th Congress will consider legislation that continues to move the system in that direction.

⁹ Note that the CEN-NN-CIN framework has limited use as an analytical framework under a consumption tax. In this way, the consumption tax is similar to the AJCA’s domestic production deduction. While it poses an incentive for domestic investment, it is in contrast to traditional prescriptions for NN in that the shift to domestic investment would occur because of a tax cut for domestic investment rather than a tax increase for investment abroad; the benefit of the shift would thus likely principally accrue to domestic capital rather than labor.

Taxes and Offshore “Outsourcing”

A high-profile topic of debate was offshore outsourcing — generally, the real or perceived movement of jobs from the United States overseas.¹⁰ A principal way taxes are thought to abet what is sometimes described as the “export of jobs” is by encouraging U.S. firms to invest abroad, and to establish foreign operations rather than operations in the United States. As described above, deferral and in some cases cross-crediting poses an incentive for overseas investment.

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

Proposed Legislation in the 110th Congress

H.R. 3970: Tax Reduction and Reform Act of 2007

H.R. 3970 contains a number of provisions that would change the current law concerning the tax treatment of overseas income and investment.¹¹ Under current law, income from foreign subsidiaries of U.S. firms is not taxed until it is repatriated (in the form of dividends) to the parent firm. At the same time, the parent firm is able to deduct costs, the most important of which is interest, even though some of that cost is associated with income that is not immediately subject to U.S. tax. Such treatment essentially allows firms to use foreign tax havens to effectively shift profit out of the United States and its tax system. The allocation rule would deny the portion of deductions associated with this income until the income is repatriated and subject to tax. Companies investing in non-tax-haven countries could avoid the allocation rule by repatriating income.

An additional allocation provision would repeal a rule that involves world wide interest for the foreign tax credit. When income from abroad is subject to U.S. tax (either as branch income or repatriated income), a foreign tax credit is allowed for foreign taxes paid up to the U.S. tax due. For firms that have more foreign taxes paid than allowable credits, increasing the amount of income allocated abroad increases allowable foreign tax credits and reduces U.S. tax liability. Prior to 2004, U.S. source interest was allocated between foreign and domestic incomes based on relative magnitude of foreign and domestic assets. The 2004 provision included interest on foreign borrowing as well as debt-financed investment in the calculation, which

¹⁰ For additional information on taxes and outsourcing, see CRS Report RL32587, *Taxes and Offshore Outsourcing*, by Donald J. Marples.

¹¹ For a complete description of the provisions in H.R. 3970, see CRS Report RL34249, *The Tax Reduction and Reform Act of 2007: An Overview*, by Jane G. Gravelle.

would allocate more domestic interest to domestic source income, a reduction in interest allocated to foreign income, and a resulting increase in the foreign tax credit limit.

Another provision relating to international tax issues is intended to reduce “treaty-shopping.”¹² The United States imposes withholding taxes on interest, royalties, and similar payments to foreigners, but also engages in a number of treaties with other countries where these withholding rates are reduced. A firm in a country without a treaty can benefit by setting up a subsidiary in a treaty country to avoid the withholding tax, and this provision would eliminate that benefit.

Two provisions relate to inventory accounting. While inventories are most important in the manufacturing and trade sectors of the economy, the economic consequences of a change in the taxation of inventories are likely small — due to, generally, short holding periods for inventory.¹³

Arguably the most significant proposed change contained in H.R. 3970 is the repeal of a provision that allows last-in, first-out (LIFO) accounting for inventories. In this form of inventory, the good being sold is assumed to be the last acquired and since, in general, prices tend to rise over time, this method increases the cost of the good sold and reduces profit (and therefore tax liability). The other inventory method is first-in, first out (FIFO), where the good sold is assumed to be the first acquired, and thus includes any price increases in income. Firms must use the same inventory method for tax and book purposes; as a result, many firms that would find LIFO advantageous nevertheless use FIFO because profits reported to shareholders would be lower under LIFO. LIFO accounting may, on average, result in a more accurate measure of income because it has the effect of indexing cost and not capturing increases in value due to inflation. At the same time, when relative prices are changing, such as oil prices, it allows firms to avoid tax on windfall gains. In general, the economic consequences of taxing the return to inventories at a higher or lower rate are probably not very important; because of the short holding period for most inventories, the tax on the return is a very small part of the cost.

A second inventory provision eliminates the option to value inventories at market value rather than at cost. Allowing this option permits the recognition of losses in inventory even though the items have not been sold, a treatment inconsistent with the general realization principle for gains and losses.

¹² For additional information on “treaty-shopping,” see CRS Report RL34245, *Tax Treaty Legislation in the 110th Congress: Explanation and Economic Analysis*, by Donald J. Marples.

¹³ See Jane G. Gravelle, *The Economic Effects of Taxing Capital Income*, (Cambridge, MA, The MIT Press), 1994, p. 300.