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# Traditional Tax Doctrine for Foreign Income

The previous chapter stressed that US taxation of international business income is an offshoot of the taxation of domestic business income. But it is a hardy offshoot. Beginning with the Revenue Act of 1962,<sup>1</sup> the US system of taxing international income has grown enormously complex, a rich vineyard in which tax accountants and attorneys labor over intricate regulations, debate complex fact patterns, and draw on sophisticated computer analysis to structure single transactions, whole operations, and entire corporate groups. We do not wish to lay out and critique the mind-numbing details of current tax law (see appendices A1 to A8 for a primer); rather, this chapter concentrates on the landmarks of US tax doctrine as they apply to international business income.<sup>2</sup> Most tax experts are familiar with these landmarks, and they should skip immediately to chapter 4, in which we propose a new regime for taxing portfolio investment income.

Despite sea changes in the world economy, the intellectual underpinnings of the US approach to taxing international business income have changed little in eight decades. The complexity of present US law reflects not new architecture but rather an extensive patchwork to repair a

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1. This act introduced subpart F, a complex set of revisions designed to tax currently the undistributed earnings of subsidiaries incorporated in tax haven countries.

2. This chapter and chapters 4 and 5 rely heavily on work done by Daniel J. Frisch when he was a senior fellow at the Peterson Institute for International Economics (1989–90). His work is paraphrased in this chapter by his permission and that of *Tax Notes*. See Frisch (1990).

succession of leaks. Thus the US Treasury, in laying out reform proposals in 1985, adhered to the same rationale that has guided US taxation of international income for the entire century. Because it illuminates the stolid quality of official thought, the Treasury discussion is worth quoting at length:

The Administration proposals retain the basic structure for taxing foreign income of US taxpayers that has evolved since 1913. This structure is intended to cause foreign income to bear a fair share of US tax in a manner that does not distort investment decisions; at the same time, special measures reflect concern for the international competitiveness of US business. Thus, the general rule is that US taxpayers are subject to US tax on their worldwide income. A credit is allowed against US tax for foreign income taxes paid in order to avoid double taxation of foreign income which has been taxed by the country where the income is earned. The special measures include the deferral of US tax on income earned by US-controlled foreign corporations until that income is remitted to US shareholders. (Certain tax haven income is, however, taxed to the US currently even though not repatriated.) . . .

In reaching the decision to continue the worldwide taxation of US taxpayers with allowance for foreign tax credits, the Administration considered and rejected the alternatives of exempting foreign-source income from US tax, or taxing foreign-source income but only allowing a deduction for foreign taxes. While an exemption approach would in some circumstances facilitate overseas competition by US business with competitors from countries that tax foreign income on a favored basis, such an approach also would favor foreign over US investment in any case where the foreign country's effective tax rate was less than that of the United States. Moreover, there would be a strong incentive to engage in offshore tax haven activity. The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions. Exempting foreign income from tax would favor foreign investment at the expense of US investment. The other alternative, to allow only a deduction for foreign taxes, would not satisfy the objective of avoiding double taxation. Nor would it promote tax neutrality; it would be a serious disincentive to make foreign investments in countries where there is any foreign income tax. (*The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, 1985, Washington: Government Printing Office, A383)

As the quote reveals, policymakers have historically considered three broad frameworks for tax policy toward the foreign income of US taxpayers: taxation with a credit for foreign taxes, taxation with a deduction, and exemption of foreign income. Under a credit system, foreign taxes paid on business income earned abroad are credited dollar for dollar against US tax liability on that same income. Under a deduction system, foreign taxes are deducted from business income earned abroad, and US tax liability is calculated on the after-foreign-tax income. Under an exemption system, business income earned abroad simply is not taxed domestically.

The United States historically has chosen the first of these alternatives, taxation with credit for foreign taxes, though a landmark shift in of-

ficial thinking occurred in the President’s Advisory Panel on Federal Tax Reform (2005). The panel, which was staffed by the Treasury Department, recommended a territorial system for “active” business income earned abroad. This recommendation echoes the reform advocated in the first edition of this book (Hufbauer 1992).

Returning to the historical thread, as late as 1985, it was taken for granted that income earned by foreign corporations raised no special issues and should be taxed in the same way as US income earned by US corporations operating domestically. It was also taken for granted that measuring corporate income earned within the United States, though tedious and complex, was basically a technical issue, not a policy question. The policy debate, up through passage of the Tax Reform Act of 1986, thus focused on the foreign income of US corporate taxpayers.

The three options for taxing US taxpayers on their foreign income correspond to three distinct schools of thought on taxation, each of which considers its doctrine to be the proper basis for policy. Historically, the three competing doctrines were capital export neutrality (CEN), national neutrality (NN), and capital import neutrality (CIN).<sup>3</sup> To this familiar trio, Desai and Hines (2004) have recently added two new benchmarks: capital ownership neutrality (CON) and national ownership neutrality (NON). We discuss these newer benchmarks after reviewing the older and more familiar concepts.

Three issues are at stake in the policy debate among the advocates of the CEN, NN, and CIN approaches.<sup>4</sup> The first is the worldwide efficiency question: Which tax regime, jointly operated by two or more sovereign jurisdictions, does the least harm to the efficient workings of the international economy? The second is the national prosperity question: How does a tax regime affect economic activity in each country? The third is the division-of-revenue question: How much tax should each government collect?

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3. The concepts of CEN and CIN were first clearly articulated by Richard Musgrave (1960), but they were implicit in international tax circles much earlier. Peggy Richman (1963) laid out the concept of NN. The history of the different concepts is summarized in Bergsten, Horst, and Moran (1978); see also Caves (1982).

4. CEN takes its name from the proposition that business income should be taxed to the same extent whether the firm’s capital is used to make goods and services at home or exported and used to make goods and services abroad. CIN reflects the proposition that capital originating in a foreign country should be taxed in the same manner as home-grown capital. NN is named for the proposition that capital-exporting countries should derive the same income from capital—private returns plus public tax revenue—whether it is employed at home or abroad.

## Capital Export Neutrality

In the United States, unlike in other industrialized countries, CEN has traditionally prevailed at a conceptual level over competing tax doctrines, though not decisively so. The paramount goal of CEN is to prevent tax considerations from distorting the choices made by multinational enterprises (MNEs) when they decide to locate production or headquarters activity in one country or another. Scarce capital is thereby allocated efficiently on a worldwide basis, and national prosperity supposedly follows. In academic expositions of CEN, the division-of-revenue question is distinctly secondary; nevertheless, the prospect of gaining more revenue for the US Treasury has been a driving force in legislative episodes of trying to implement CEN doctrine.

The CEN ideal as conceived in the United States entails a set of tax rules designed so that managers of US-based MNEs can ignore income tax considerations when deciding whether to locate a plant in the United States or abroad. The goal is achieved if US firms pay the same tax rate on corporate profits, and if those profits were measured the same way, no matter where the firms put their investments. The CEN school believes that such a system can lead to the most efficient possible allocation of capital around the world, and thus to the most productive world economy.

Before descending into the details of CEN, it is worth pointing out that the CEN school assesses tax policy in isolation from a variety of other policies that might distort the location of investment. For example, protective tariffs, buy-national public procurement, and capital grants to firms can all tilt plant location decisions, but according to the CEN school, these other policies should be corrected on their own turf; the tax code is not the place to offset the great variety of distortions that governments inflict on the international economy.

In principle, CEN is achieved by using the same rules to measure both foreign and US income, taxing income earned abroad at the US corporate rate as it is earned, allowing the same investment tax credits and accelerated depreciation for foreign investment as for domestic investment, and granting a credit for foreign income taxes paid.<sup>5</sup> Suppose a US-based MNE could earn a before-tax return of 25 percent, either in Belgium or in the United States, on a plant addition costing \$40 million. In either case the annual before-tax return would be \$10 million. Suppose the Belgian corporate tax rate, after special depreciation allowances, works out to 20 percent versus the US rate of 35 percent. Under a CEN system, the US tax on Belgian profits would be \$3.5 million ( $\$10 \text{ million} \times 35 \text{ per-}$

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5. This menu was recommended by Bergsten, Horst, and Moran (1978, 461–62). They also suggested extending the investment tax credit to foreign investment; that proposal is now moot, as the investment tax credit was repealed by the Tax Reform Act of 1986.

cent); the United States would allow a foreign tax credit of \$2.0 million ( $\$10 \text{ million} \times \text{the Belgian tax of 20 percent}$ ); and the net US tax after credit would be \$1.5 million ( $\$3.5 \text{ million} - \$2.0 \text{ million}$ ). The firm's after-tax return would then be the same (\$6.6 million) whether it located the plant addition in the United States ( $\$10 \text{ million income} - \$3.5 \text{ million in US tax}$ ) or in Belgium ( $\$10 \text{ million income} - \$2.0 \text{ million in Belgian tax} - \$1.5 \text{ million in US tax}$ ). In short, under a CEN system, when before-tax returns are the same in two locations, the after-tax returns are also the same. The tax regime does not prejudice the plant location decision; in this case, the firm could simply toss a coin.

Similarly, if the US before-tax return were greater, so would be the after-tax return, and the firm would build the plant addition in the United States. Extending the case above, if the MNE could earn \$12 million before tax by making its \$40 million plant addition in the United States, but only \$10 million in Belgium, it would invest in the United States because its after-tax return would be higher (\$7.8 million versus \$6.5 million). If the facts were reversed, it would invest in Belgium. From the CEN standpoint, these would be correct decisions. Worldwide efficiency is maximized when the tax rules encourage firms pursuing their financial self-interest to place their capital where it earns the highest before-tax return. To achieve this, the combined domestic and foreign tax rate must be the same no matter where the domestically based firm puts its capital.

In contrast, if the domestic authorities do not tax foreign income at all—as the CIN school urges—then domestically based firms have an incentive to move their capital to low-tax or zero-tax countries. The effect is the same whether low or zero effective taxation is achieved by a low or zero nominal rate or by special incentives, such as generous depreciation allowances: Too much capital flows to these locations, and that capital is less productively engaged, at the margin, than capital placed in the United States.

Returning to the previous example, suppose that the United States did not tax the profits of the MNE's Belgian subsidiary. The MNE would then prefer an investment in Belgium that earned \$10 million before tax even if the same investment in the United States earned \$12 million before tax: The firm's after-tax return would be \$8.0 million on the Belgian investment after the Belgian tax of 20 percent, but only \$7.8 million on the US investment after the US tax of 35 percent. The tax regime thus would prompt US-based MNEs to allocate their capital inefficiently from a global perspective—too much in Belgium, too little in the United States.

However, if the United States allowed a deduction but no credit for foreign taxes—as the NN school urges—then US MNEs would pay tax twice on income from capital located abroad. The opposite incentive would be created: Too little capital would be used abroad, and that capital would be more productive, at the margin, than capital used in

the United States. Again, the efficiency of the world economy would be impaired. Applying the rule of deduction but no credit to the previous example, the after-Belgian-tax, after-US-tax income from a Belgian investment that earned \$10 million before tax would be only \$5.2 million (\$10 million – the deduction for the 20 percent Belgian tax = \$8 million to be taxed by the United States; \$8.0 million taxed at 35 percent leaves \$5.2 million for the corporation). In contrast, even if the same project located in the United States earned only \$9 million before tax, it would show a higher after-tax return (\$9.0 million taxed at 35 percent leaves \$5.9 million). The tax system would encourage the US investment, even though it was less productive than the Belgian investment.

Hence the CEN prescription to tax foreign income on a current basis, but allow foreign taxes paid to offset the domestic tax dollar for dollar, so that domestic tax on foreign income is paid only when the income is taxed abroad at a lower rate. This way, the combined total foreign and domestic tax on the foreign income of domestic firms equals the domestic tax on income earned at home.<sup>6</sup>

Even in the halcyon days of the 1950s and 1960s when US firms dominated global business and the United States took a benign view of international capital flows—seeing no inconsistency between world efficiency and national prosperity—there was acute practical concern about the third goal of international tax policy, the division of revenue between US and foreign governments. For this reason, no one in Treasury or Congress was prepared to carry the foreign tax credit component of CEN doctrine to its ultimate conclusion, namely, crediting US MNEs for taxes paid abroad in excess of their US tax liability on the foreign income.<sup>7</sup> As early as 1921 the foreign tax credit was limited to the US tax that would otherwise be due on foreign income (see appendix A1).

Limiting the foreign tax credit, however, might impede the CEN school's goal of worldwide efficiency. Consider a US-based MNE with foreign income that is, on average, taxed more heavily abroad than it would be in the United States. Under the US foreign tax credit system, no additional US tax is due on this income, but the excess foreign tax is neither refunded nor allowed as a credit against US tax on US income. Instead, the so-called excess credits are disallowed entirely if they cannot be used during carry-back or carry-forward periods. Thus US-based MNEs might avoid investing in countries with heavier taxation than the United States, and consequently too little capital for worldwide efficiency

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6. To carry out this prescription, the same accounting rules and depreciation allowances should apply to foreign and domestic income, and any domestic tax incentives should be extended to foreign investment.

7. Likewise, in the years when the investment tax credit was allowed, it was not extended to foreign investment.

might end up in these high-tax countries.<sup>8</sup> In practice, however, the overall limitation is an important offset: US-based MNEs can usually blend their high-foreign-tax income with their low-foreign-tax income and enjoy the benefit of the foreign tax credit for taxes paid to high-tax countries.<sup>9</sup>

Although the CEN school recognized early the possible problem of a self-inflicted capital shortage in high-tax countries, even its academic proponents never seriously suggested removing the limitation on the foreign tax credit. Allowing the overall limitation was concession enough, as division-of-revenue concerns trumped worldwide efficiency concerns. The absence of a foreign tax credit limit would provide a strong temptation for foreign governments to encroach on the US tax base. With no limit on the credit, foreign governments would feel rather free to tax US firms more heavily than the US corporate tax rate does, as the extra burden would fall not on the firms, thereby encouraging them to leave, but on the US Treasury.

Another practical reason for the foreign tax credit limit became apparent in the mid-1970s. If a sovereign government owns natural resources, imposes a corporate tax, and leases the extraction rights to a private company—a very common practice in the petroleum industry—it may be hard to distinguish between the tax on corporate income and the royalty paid for resource rights, particularly when the tax and royalty systems are designed with the assistance of capable US legal counsel. In such circumstances, the foreign tax credit limit at least restricts the amount of resource royalties that can be disguised as a corporate tax.

Apart from the limit on the foreign tax credit, there is another large departure in the US tax rules from the CEN prescription that the combination of domestic and foreign taxes on corporate income be the same wherever the income is earned. The worldwide income of US firms is not

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8. As discussed in chapter 2, according to traditional analysis an appropriate degree of currency depreciation can preserve economic activity in the high-tax country. However, currency depreciation works (if at all) by raising the before-tax return to capital, so that even if economic activity is preserved, there remains the distortion between jurisdictions in before-tax rates of return. Capital remains too scarce in the high-tax jurisdiction and too plentiful in the low-tax jurisdiction.

9. The United States historically permitted an overall limit on the foreign tax credit rather than requiring a per-country limit. The overall limit allowed MNEs to blend income from low-tax foreign jurisdictions with income from high-tax foreign jurisdictions, thereby claiming a larger credit for foreign taxes imposed by high-tax countries. This feature mitigated the disincentive to invest in high-tax jurisdictions. However, with the separate baskets-of-income approach to the foreign tax credit introduced by the Tax Reform Act of 1986 (see appendix A1), the blending possible under the overall limit found somewhat less scope for investments in high-tax jurisdictions. The American Jobs Creation Act of 2004 (see appendix A1) slashed the number of baskets from nine to two (passive-category income and general-category income), starting in 2007, thereby restoring the scope for blending high-tax and low-tax income.

taxed in the current year if it is earned by locally incorporated subsidiaries engaged abroad in a so-called active trade or business. Instead, US tax on the business profits of these subsidiaries is deferred until the profits are repatriated to the US parent company as dividends, or until the subsidiary is sold; in the latter case, the subsidiary's retained earnings are taxed as ordinary income up to the amount of retained earnings realized as profits by the sale, and profits beyond the amount of retained earnings are taxed as a capital gain. Foreign income derived from so-called passive sources is taxed currently.<sup>10</sup> This exception to deferral was first introduced in the Revenue Act of 1962, and since then, the definition of passive income has been progressively expanded.

Assuming that before-tax earnings would be the same in the United States as in a low-tax location, the present value of the expected stream of combined US and foreign taxes on foreign income can be significantly lower when US taxation is deferred. In present-value arithmetic, a delayed tax is a smaller tax. Suppose the MNE in the above case expected to earn \$10 million annually on an investment in the United States and pay a tax of 35 percent at the end of each year over the next 10 years. The present value, at the beginning of the first year, of the expected stream of future US taxes, discounted at 10 percent annually, would be \$21.5 million.<sup>11</sup> However, suppose the MNE expected to earn \$10 million annually in Belgium, pay a Belgian tax of 20 percent over the next 10 years, sell the investment in the 10th year, and only then pay US tax on the retained earnings with a credit for prior Belgian taxes. In that case, the present value of the expected stream of Belgian and US taxes, again discounted at 10 percent annually, would be \$18.1 million.<sup>12</sup> The before-tax returns are identical on the two investments (\$10 million per year) and the tax burdens without a deferral would be the same (\$35 million over 10 years), but the practice of deferral, coupled with the workings of compound interest, makes the Belgian investment decidedly more attractive.

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10. Broadly speaking, active income is derived from mining, manufacturing, and performance of business services such as accounting; passive income is derived from collecting dividends, interest, rents, and royalties. Perennial gray areas between active and passive income include trading, banking, insurance, and leasing, businesses with a fuzzy line between mobile and immobile sources of income.

11. In this case, the present value (PV) of the future tax stream is calculated as  $PV = \$3.5 \text{ million}/(1.10) + \$3.5 \text{ million}/(1.10)^2 + \dots + \$3.5 \text{ million}/(1.10)^{10}$ .

12. Calculated as  $PV = \$2.0 \text{ million}/(1.10) + \$2.0 \text{ million}/(1.10)^2 + \dots + \$2.0 \text{ million}/(1.10)^{10} + \$15 \text{ million}/(1.10)^{10}$ . The figure of \$15 million in the last term represents the cumulative difference over 10 years between US tax on undistributed earnings (\$3.5 million per year) and the foreign tax credit attributable to Belgian tax (\$2.0 million per year). When the investment is sold, the United States will finally collect its \$1.5 million per year of tax, or \$15 million total.

The above arithmetic gives US firms an incentive to operate in low-tax countries. Studying the effects of foreign tax havens on American business, Hines and Rice (1990, 36) concluded that “it is undoubtedly true that some American business operations are drawn away from the mainland US by the lure of low tax rates in tax havens.” Subsequent empirical research confirms that the US international tax system does not neutralize host-country tax advantages that affect US-based MNEs when choosing among competing foreign locations.<sup>13</sup> In other words, US-based MNEs are sensitive to host-country tax rates in their outbound operations. Given the multiple holes in the current quasi-CEN system, Altshuler and Grubert (2001, 36) concluded that location decisions as between competing foreign countries would not be significantly affected if the United States adopted a dividend exemption system (i.e., a quasi-territorial system). Taken as a body, the empirical evidence has led economists to state that, in the current tax climate, US-based MNEs behave as if they were subject to a territorial tax system, at least with regard to investment choices across foreign locations.<sup>14</sup>

From a CEN standpoint, the theoretical solution to the problem of tax competition is to repeal deferral across the board so that all foreign earnings of US subsidiaries are taxed currently after allowing for the foreign tax credit, whether or not the earnings are currently repatriated as dividends.<sup>15</sup> CEN proponents claim that the changes will not only improve worldwide economic efficiency, but also help to curb the spread of so-called harmful tax competition,<sup>16</sup> the invocation of which became a rallying cry in the 1990s. According to the argument, some countries take undue advantage of globalization—that is, the mobility of capital and

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13. See Mutti (2003); Altshuler, Grubert, and Newlon (2001); Grubert and Mutti (1998, 1999); and Hines and Rice (1994). These papers focus on investment choices across foreign locations and not between domestic and foreign jurisdictions.

14. See Altshuler (2000) and Altshuler and Grubert (2001). Analyzing empirical work, Altshuler and Grubert (2001) conclude that “the current system provides similar tax incentives to the ones we would expect under a system in which dividends are exempt from home country taxation.” However, they note that one critique of this interpretation of the literature is that “the empirical tests do not explicitly test the impact of residual home country taxes on location behavior.”

15. In the 1970s some observers regarded the denial of investment tax credits and accelerated depreciation to foreign investments as offsets to deferral, and thus saw the repeal of deferral as less urgent from the standpoint of CEN doctrine (Bergsten, Horst, and Moran 1978; Hufbauer and Foster 1976). Both the investment tax credit and the most favorable elements of accelerated depreciation were repealed in 1986, so the CEN case for ending deferral is stronger today.

16. The Organization for Economic Cooperation and Development (OECD 1998) has adopted initiatives to cope with harmful tax competition. The initiatives are designed to curb tax havens and preferential tax regimes that are thought to erode the tax base of OECD members, thereby reducing the tax that would otherwise be collected.

skilled personnel, sophisticated financial services, and weak international tax coordination—and deliberately slash their corporate taxes to attract direct investment from MNEs. Other countries are forced to respond in kind. The result is to erode the tax base all around and distort location decisions. For the CEN school, the solution is to strike at the root: repeal deferral and impose a strict per country (or even per subsidiary) limit on the foreign tax credit, so as to curb the effect that tax differentials have on MNE decisions about where to invest. Supposedly such measures deter countries from engaging in harmful tax competition.

However, the CEN line of analysis raises the question of whether the United States should be concerned about the efficiency of capital allocation among foreign countries and even among lines of business in those countries. If the United States were concerned about this sort of micro-efficiency, it would impose per country, per subsidiary, and even per type-of-income limits on the foreign tax credit, as well as repealing deferral. Particularized limits on the foreign tax credit would be required to prevent the income earned in low-tax countries, or from low-tax activities, from being sheltered against US taxation through excess credits generated by high-tax sources of foreign income. If the Singapore tax rate on a new biotech plant is only 10 percent thanks to a tax holiday, but if the returns from the biotech investment could be sheltered from further US tax through excess credits stemming from a 40 percent tax rate on the US-based MNE's income earned in Germany,<sup>17</sup> the MNE would have every reason to pursue the Singapore investment. Under the Tax Reform Act of 1986, the United States imposed such quasi-per-type-of-income limits on the foreign tax credit through a complex system of baskets of income, but this change was inspired more by revenue considerations than by micro-efficiency concerns. Consequently, considerable latitude remained for micro-inefficiency after the 1986 act.

The American Jobs Creation Act of 2004 (AJCA, PL 108-357) consolidated the baskets of income from nine to two, a passive category and a general category. The passive income basket was expanded to absorb three other baskets: dividends from a domestic international sales corporation (DISC), distributions from a foreign sales corporation (FSC), and foreign trade income. The remaining five baskets were combined into the general category basket.<sup>18</sup> These changes greatly simplified the foreign tax credit system but also increased room for micro-inefficiency.<sup>19</sup>

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17. Under the 1989 US-German tax treaty, the tax on distributed earnings of a German subsidiary was 36 percent plus a withholding tax of 5 percent.

18. For an analysis of the changes to the foreign tax credit limitations and other provisions of the AJCA, see Tuerff et al. (2004).

19. Consolidating the number of baskets of income increases the opportunity for cross crediting. Subdividing categories of income into smaller baskets has the opposite effect. Allowing for cross crediting can move the tax system closer or farther from CEN, depending on

All in all, it is fair to conclude that the present structure of US taxation of foreign income—the foreign tax credit with basket-of-income limits, coupled with deferral for so-called active income and current taxation for so-called passive income—reflects a pragmatic compromise between CIN and CEN, and thus between business firms and the US Treasury. Businesses are concerned about maintaining international competitiveness, or at least that is the proclaimed rationale for deferring taxes on active foreign income. The Treasury is concerned about defending US tax revenues, the real if unproclaimed rationale for basket-of-income limits on the foreign tax credit and current taxation of passive foreign income.

Historically, the step-by-step implementation of CEN logic (see appendix A1) meant higher taxes on the foreign income of US business.<sup>20</sup> Hence the Treasury historically advocated CEN doctrine while business espoused CIN theory.

However, as we will see shortly, recent empirical research indicates that further moves toward CIN might actually increase tax revenues depending on the specific features of the territorial tax system adopted. As a result, it is not surprising that Treasury is gradually losing its historic affection for pure CEN doctrine, as revealed in the recommendations of the president's tax reform panel (see appendix A3). For symmetrical reasons the business community could support certain CEN arguments. Signs of this historic reversal were first observed a few years ago in both Treasury and the private business sector. In 2002 the Treasury Department called for an examination of the merits of an exemption-based (territorial) tax system.<sup>21</sup> In the same year,

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the foreign tax credit position of the US-based MNE involved. If deferral were repealed, US-based firms in an excess limitation position (i.e., foreign tax credit limits in excess of foreign taxes paid) would be indifferent between investments that earned the same income in the United States and in low-tax countries abroad because they would face the same combined tax rate on foreign income. For these firms, the system would be closer to CEN. Meanwhile, US-based MNEs in excess credit positions would prefer investments in low-tax countries over investments in the United States or other high-tax countries; as with cross crediting, taxes paid to high-tax jurisdictions would eliminate any residual tax owed to the Internal Revenue Service (IRS) on income from low-tax jurisdictions. For these firms, the consolidated basket-of-income approach moves the system farther from CEN and closer to CIN.

20. The AJCA retreated from CEN logic by consolidating baskets of income, reforming Subpart F to exclude certain types of base company sales and service income, and providing a one-year low-rate "tax holiday" for repatriating foreign earnings. These changes were advocated by Chairman Bill Thomas (R-CA) of the House Ways and Means Committee, even though Treasury opposed them.

21. See the Treasury Report on Inversion Transactions, 2002 (appendix A5). In a 1977 study on tax reform, Treasury advocated CEN in the context of residence-based taxation. In 1999 the Treasury reiterated its support for CEN connected to a comprehensive study of deferral. By contemplating the CIN framework, the 2002 report departed from past Treasury doctrine. The departure was underscored by the territorial system endorsed in the 2005 report of the president's tax reform panel.

the National Foreign Trade Council (NFTC) argued against replacing the current tax system with a territorial system.<sup>22</sup>

The most significant legislative step away from CEN logic was the AJCA (HR 2896), introduced by William M. Thomas (R-CA), chairman of the House Ways and Means Committee, on July 25, 2003. It was eventually passed as HR 4250 and signed into law on October 22, 2004 (see appendix A5). Two central purposes of the bill were to replace the FSC and extraterritorial income exclusion (ETI) regimes—both found to be illegal export subsidies by World Trade Organization (WTO) rulings<sup>23</sup>—and to discourage corporate inversions. To compensate US exporters for the repeal of the FSC/ETI regimes, the bill contained several provisions designed to make US firms more competitive internationally. Features in the bill that generally followed CIN logic included a low-rate, one-year (2005) tax holiday for accumulated earnings held by foreign subsidiaries, known as the Homeland Investment Act; a reduction in the number of foreign tax credit baskets from nine to two, permitting more cross crediting of taxes; changes in foreign base company sales and service rules, making them less unfriendly to the foreign activities of US-based multinationals; a reform in interest allocation rules to reflect foreign borrowing by subsidiary corporations; extension of the five-year foreign tax credit carry-over period to ten years; and the addition of a one-year carry-back provision.

Prior to the introduction of the AJCA, the adoption of the entity classification regulations under Section 7701 of the Internal Revenue Code (the so-called check-the-box regulations) in 1997 also contributed to a de facto shift of the US international tax system towards CIN logic.<sup>24</sup>

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22. In 2002 the NFTC—an association of businesses with some 550 members, devoted to international trade and investment issues—launched an international tax-policy review project designed to consider US international tax reform in the form of a territorial tax exemption system associated with CIN. The NFTC argued that legislative efforts to improve current international tax rules were better spent on reforming the current deferral and foreign tax credit system than on adopting a territorial exemption. The NFTC concluded that “while it is true that a territorial system could improve competitiveness and simplicity for some US-based companies with substantial operations abroad, the accompanying reduction in foreign tax credits attributable to exempt income could more than offset that benefit for other such companies. Moreover, the benefit for any significant group of companies would be dependent on the adoption of a broad exemption, a cutback on the existing Subpart F rules, and reform of the current expense allocation rules” (NFTC 2002a).

23. See Hufbauer (2002) for a detailed discussion.

24. From 1960 through the end of 1996, classification of a business organization as either a “partnership” or as a “corporation” was accomplished by reference to the so-called Kintner Regulations issued under IRC Section 7701. The Kintner Regulations based the classification determination on the presence or absence of four factors and generally weighted the classification test in favor of partnership classification. The check-the-box regulations, which became effective on January 1, 1997, replaced the four-factor Kintner classification test for

Although the check-the-box rules were never intended to circumvent the US antideferral rules, check-the-box planning to avoid subpart F has become the norm for US-based MNEs. This was achieved by various techniques. One of the most popular is to consolidate all the overseas operations of a US-based MNE under a single offshore holding entity and then file a check-the-box election to treat this first-tier foreign holding company as a “corporation” for US tax purposes. As a result of the election, payments that are deductible locally (such as interest, royalties, rents, etc.), made amongst the various foreign subsidiaries or between the subsidiaries and the first-tier foreign holding company, that might previously have been subject to current US taxation under subpart F, effectively circumvented the subpart F regime (Sicular 2007).

The enactment of section 954(c)(6) in 2006 (see appendix A3) constituted a further step away from CEN logic. Section 954(c)(6)—which, as of July 2007, is scheduled to sunset in 2009—provides for look-through treatment for dividends, interest, rents, and royalties received or accrued by a CFC from a related CFC attributable to non-subpart F income of the payer CFC, thereby effectively permitting deferral for most active earnings of a CFC.<sup>25</sup>

## National Neutrality

Unlike the CEN school, the NN camp is not particularly interested in maximizing the efficiency of the world economy by allocating capital to locations where it earns the highest before-tax return. The NN school, which has never prevailed in the public policy debate, would prefer to orient US tax policy to maximize US gains from the use of US-owned capital. National prosperity is thus the paramount goal of the NN school, and its proponents—a very small band—seek to achieve it by dramatically boosting the US tax take on foreign investment, thereby discouraging US-based MNEs from production abroad.

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classifying business organizations as either partnerships or corporations. The regulations allow certain business entities to choose their classification for US tax purposes under an elective regime, including providing an election to classify certain foreign entities as “partnerships”, “corporations” or “disregarded entities” for US tax purposes if certain conditions are met, regardless of the classification of such entities from a local corporate law perspective.

25. Sicular (2007) states that “[o]n the surface Section 954(c)(6) looks like a narrow technical rule.” In fact, it is much more than that. If it becomes permanent, section 954(c)(6) will have, without fanfare, effectively repealed antideferral rules for much of what subpart F was originally intended to reach—payments of “passive” income between controlled foreign corporation (CFCs).

Consider the decision by a US-based MNE concerning an investment that promises to yield a profit of 20 percent annually in either of two locations: in the United States or in a foreign country that will tax the income at the same 35 percent US corporate rate. Worldwide efficiency is unaffected by the choice of location, as in either case, the before-tax return on capital is 20 percent. But the choice matters to the United States, according to the NN school.

One reason why it should matter is very simple: In one case the United States collects the tax revenue, whereas in the other case a foreign government collects the revenue. Moreover, to add a modern twist, in one case the United States enjoys the spillover benefits of new investment, such as externalities and particularly technological spillovers, whereas in the other case those benefits are enjoyed abroad. Thus instead of treating foreign taxes as an offset to US taxes, NN doctrine considers them as a cost of employing US capital abroad. Like other costs of doing business, NN would allow these costs to be deducted from taxable income, but they could not be credited against US federal taxes.<sup>26</sup>

The change from a credit to a deduction would prompt US MNEs to alter the international disposition of their assets until they earned the same before-US-tax (but after-foreign-tax) rate of return, whether investing in the United States or abroad. For example, if an investment earned 28.6 percent before tax and was taxed at 30 percent by France, the before-US-tax return would be 20 percent (70 percent of the initial 28.6 percent return). Under NN rules, the French investment would be equally attractive to the US MNE as a US investment with a before-tax return of 20 percent. In both cases the United States would tax the 20 percent before-US-tax return at its own 35 percent rate, and the after-US-tax return would be 13.2 percent. Either way, the US economy—that is, the US MNE and the Treasury—would earn a total return of 20 percent on US capital.

To carry the story further, the NN school would accept US-based multinational investment in France if it could earn the 35 percent pre-French tax, for then the return on capital available to the US economy would be 24.5 percent, an improvement on the 20 percent that could be earned at home (this calculation ignores any technological spillovers). But the NN school would not want the MNE to invest abroad if it could earn only the 25 percent pre-French tax, for then the return available to the US economy would be only 17.5 percent.

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26. State and local taxes on corporate income are allowed as a deduction, not a credit, against US federal income tax. But the rationale for the deduction of state and local taxes differs from the rationale urged by the NN school for the deduction of foreign taxes. If state and local taxes were creditable and not just deductible, the temptation would be overwhelming for state and local governments to raise their corporate tax take at the expense of the federal government. With important exceptions, foreign governments do not tailor their tax systems with the principle aim of capturing tax revenue from the US Treasury.

The NN view leads to a drastic recommendation for changing US tax law. Like the CEN school, the NN camp would tax the worldwide income of US MNEs currently and without deferral, but NN would replace the foreign tax credit with a deduction for foreign taxes.<sup>27</sup> This idea was the basis of the tax sections of the Burke-Hartke bill, sponsored by the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) in the early 1970s (see appendix A1). Since then, the NN star has faded, and it is rarely suggested as a serious alternative today, even though US concerns about US manufacturing in the face of international competition are as pressing today as they were in 1970. In 2006 the US trade deficit in manufactured goods was over \$574 billion, or about 36 percent of US value added by the manufacturing sector.<sup>28</sup>

The NN analysis has been criticized by economists and rejected by politicians for many reasons. An old favorite with new relevance is that NN is a shortsighted way to advance national prosperity. As with other beggar-thy-neighbor policies, if the United States adopted NN as its guiding philosophy, foreign governments might retaliate by taxing their own firms doing business in the United States on the same NN basis. More likely, as US-based MNEs gradually sold their foreign assets and reinvested in the United States, foreign-based MNEs would withdraw resources from the US economy and acquire the assets on sale abroad. After such a round of asset reallocation, it is unlikely that there would be a substantial net addition to the pool of capital productively employed in the United States. Meanwhile US-based MNEs would suffer a drastic blow to their international competitive strength. All countries, including the United States, could lose as multilateral investment collapsed. As multilateral investment shrank, system-wide advantages, in the form of benefits from both the worldwide application of proprietary technology and head-to-head competition between corporate giants, would be sacrificed. Also sacrificed would be the division of production activities into slices, each corresponding to the comparative advantage of a particular country.

## Capital Import Neutrality

The CIN school considers its rivals to be flawed for several reasons. Traditionally, CIN supporters claim that CEN and NN would place US-based MNEs at a significant competitive disadvantage in many circumstances.

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27. Because of its draconian implications, the NN prescription was labeled the “international double taxation” method by Horst (1980, 793–98).

28. For 2006 total value added by the manufacturing sector was about \$1.601 trillion according to the Bureau of Economic Analysis ([www.bea.gov](http://www.bea.gov)), and the total trade deficit in manufactured goods, by Standard International Trade Classification (SITC) 5–9, was about \$574 billion (UN Comtrade database, available at [www.comtrade.un.org](http://www.comtrade.un.org)).

Consider possible investment in a low-tax location. If, under CEN logic, a US firm had to pay tax currently (without deferral) at a higher US rate on the resulting income, it would be unable to compete with either a local firm or, just as important, with a subsidiary of a foreign MNE based in a country that did not tax overseas income.

Many industrial countries effectively exempt the active business profits of foreign subsidiaries and branch operations from domestic tax. Countries that fully or partially take this approach—often called the territorial approach—include Germany, France, the Netherlands, and Canada. To achieve tax parity with multinationals based in such countries, the CIN school recommends that the United States refrain from taxing its MNEs on their active foreign income, and at a minimum, reverse the inroads on deferral made by the Tax Reform Act of 1986 (see appendix A3), as deferral has much the same effect as exemption as long as the earnings of the low-tax subsidiary are reinvested abroad, as they may be for a very long time.

Reflecting such arguments, the American Jobs Creation Act of 2004 did two things: It provided a one-year, low-rate “tax holiday” on repatriated earnings (the Homeland Investment Act provisions),<sup>29</sup> and it consolidated and simplified antideferral rules that repeal separate regimes for foreign personal holding companies and foreign investment companies. Subpart F rules were also relaxed, allowing profits from aircraft leasing and shipping income as well as commodity sales and hedging transactions to avoid being counted as subpart F income (which would disallow deferral) provided that they were directly related to the firm’s active business pursuits (Tuerff et al. 2004).

In recent years, the CIN school and sympathetic scholars have also argued that the concept of worldwide economic efficiency that CEN proponents pursue is outdated and should no longer be the core principle of US international tax policy. Among the reasons cited, the following are worth mentioning. First, for worldwide economic efficiency to be achieved, other major countries that serve as the home base for MNEs, as well as the United States, would have to endorse the CEN concept. The CIN school points out that worldwide economic efficiency cannot be achieved unilaterally by the United States, inasmuch as the relative role of the United States in the world economy had declined substantially during the last 40 years. In the 1960s the United States completely dominated the global economy, accounting for over 50 percent of worldwide cross-border direct investment and 40 percent of world GDP. In 1960, of the world’s 20 largest corporations (ranked by sales), 18 were headquar-

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29. A special dividends-received deduction was allowed equal to 85 percent of exceptional dividends repatriated in 2005. The resulting tax rate works out to about 5.25 percent, assuming that the repatriated dividends would be taxed at 35 percent otherwise.

tered in the United States.<sup>30</sup> Four decades later, the United States confronts much greater competition in global markets. As of 2005 the United States accounted for about 21 percent of the world's foreign direct investment (FDI) stock and 28 percent of the world's GDP (table 1.1), and 11 of the world's 20 largest corporations were headquartered in the United States (ranked by total revenue).<sup>31</sup>

Second, the tax reality according to the NFTC (1999) is that half of the OECD countries generally exempt foreign-source active business income from domestic taxation. Important emerging countries, such as China, also follow the exemption model in practice if not in legal form. As is discussed further below, in a world where portfolio investment can be quantitatively more important than FDI, imposing CEN only on direct investment may not improve international capital allocation.<sup>32</sup> Third, focusing on economic efficiency as a guiding light excludes other important values from consideration, for example, the pace of economic growth in developing countries and the foreign policy ramifications of overseas investments.<sup>33</sup> Fourth, strict adherence to the concept of worldwide economic efficiency, if achieved, may enhance world well being at the expense of national well being.<sup>34</sup> Fifth, not all tax competition is equally harmful; Conconi (2006) argues that some tax competition is essential to avoid excessively high taxation of capital income (see also Avi-Yonah 2000). What about the CEN argument that if foreign earnings are not taxed at the US rate, an inefficiently large amount of capital will be invested in low-tax locations instead of in the United States? CIN proponents counter that sources and

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30. See Peter R. Merrill, Director, National Economic Consulting, testimony before the House Committee on Ways and Means, Hearing on Impact of US Tax Rules on International Competitiveness, June 30, 1999 (Serial no. 106-92, 106th Congress, available at [www.worldcatlibraries.org](http://www.worldcatlibraries.org)).

31. The 11 are Exxon Mobil, Wal-Mart, General Motors, Chevron, DaimlerChrysler, Ford, ConocoPhillips, General Electric, Citigroup, AXA, and American International Group. See Fortune Global 500, 2006, available at <http://money.cnn.com> (accessed July 18, 2007).

32. For a contrary view, see Grubert and Mutti (1999).

33. Graetz (2001) claims that evaluating US international tax policy by the metric of worldwide economic efficiency, which looks only to rates of return and tax dollars collected, fails to account properly for the political benefits and burdens of foreign investments. Graetz observes that while economists tend to agree that free trade improves worldwide efficiency, the same consensus does not exist with respect to flows of capital. The International Monetary Fund (IMF) has voiced similar skepticism over the efficiency benefits of capital flows (Kose et al. 2006), but the skepticism is centered more on financial flows and portfolio investment than direct investment.

34. See Graetz (2001) and NFTC (1999). A common example is the controversy over the Treasury's hybrid-branch regulations issued in 1999. These regulations attack corporate structures with the effect only of reducing foreign rather than US tax. See the discussion in footnotes 39 and 40.

uses of world capital are interconnected through a vast global pool. If one country makes itself more attractive for investment, it draws capital from the global pool regardless of whether US or foreign firms are the identifiable investors. CIN proponents do not agree that foreign economic activity, even in low-tax locations, takes place at the expense of domestic activity. They cite empirical evidence that the reverse seems to be true, and that the foreign activity causes MNEs to expand their exports.<sup>35</sup> They conclude that it is a mistake to worry about an adverse trade-off between the domestic and foreign activities of US firms

According to CIN proponents, the United States should pragmatically recognize that, if an economic activity can most profitably be done in a low-tax location, a firm will exploit the opportunity. Directly or indirectly, capital flows from high-tax nations to low-tax nations. The real trade-off is whether the activity is done by foreign-based firms or US-based MNEs.

It is interesting to mention two recent proposals that address the policy concerns of CEN proponents, but from two different perspectives. Rosenbloom (2001) recommends a hybrid regime that includes elements of CEN and CIN. Under it, the US outbound tax system would distinguish between jurisdictions that have comprehensive rules designed to collect a significant amount of corporate income tax and jurisdictions that can be characterized as tax havens. Under Rosenbloom's proposal, foreign business income earned by controlled foreign corporations (CFCs) in the former jurisdictions would be exempt from US tax. But income earned by CFCs in tax haven jurisdictions would be fully taxed in the United States without deferral. In a similar vein, Avi-Yonah (1998b) suggests enacting "low-tax kick-in" rules that would subject active income to subpart F if not taxed elsewhere. In other words, Avi-Yonah would abolish deferral for all income that is not subject to significant taxation by the host country. By contrast, the NFTC objects to any system that differentiates between host jurisdictions based on their minimum effective tax rates. Among other objections, the NFTC cites the uncertainty and complexity that would be created for both tax administrations and taxpayers.<sup>36</sup>

To the CIN school, it is self-evident that US prosperity is advanced if US-based MNEs capture the activity. US firms can then spread fixed overhead costs<sup>37</sup> on a global basis, benefit from the challenge of operating in a new environment, and position themselves to introduce the next genera-

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35. Authoritative studies include Lipsey (2002) and Graham (2000).

36. See NFTC (2002a). The NFTC also notes that if the benefits of an exemption system were limited to tax treaty countries, the US tax treaty network would have to be expanded substantially.

37. Notably, research, development, and experimentation (RD&E) and general and administration (G&A) expenses.

tion of winning products. In short, as the NN school seeks to advance US prosperity by keeping US firms at home and the CEN school is indifferent to the location of MNE activity, the CIN school seeks to enhance US welfare by encouraging US MNEs to extend their reach. In large part, the CIN goal is accomplished by exempting the foreign corporate profits of active business firms from US taxation.

Another possible argument for CIN comes from recent literature on international trade. Strategic trade theory abandons the traditional assumption of perfect competition and provides a framework for maximizing national economic welfare in monopolistic markets. According to much strategic trade theory, and contrary to the traditional theory of free trade, it may be in the national interest to subsidize certain industries if firms in such industries will ultimately exercise market power. Intangible capital developed through RD&E expenditures or the creation of brand names may create monopolistic advantages in worldwide markets. In this case, subsidies can hasten the development of domestic industry, which can, in turn, block foreign competition. A CIN tax system can be rationalized as one method to promote frontier firms with a US base (JCT 1999).

Although CIN arguments have been made for many years, the CIN framework has yet to become official US policy. At most, the territorial approach was recommended in 2005 by the President's Advisory Panel on Federal Tax Reform (see appendix A3), but the report was not officially embraced either by the Treasury or the White House. In effect, the CIN call for territorial taxation implies that foreign investment is good for the US economy and therefore should not be taxed by the United States. But Treasury and the Joint Committee on Taxation (JCT) hear this argument about many activities, ranging from home building to oil drilling to venture capital. They are reluctant to start down the slippery slope of exempting activities from taxation, both out of concern for tax fairness and because it is difficult to delineate where tax preferences should stop. If NN doctrine can be characterized as beggar-thy-neighbor, CIN might prove to be beggar-my-government.

Yet while the CIN framework has not been adopted officially, many of its elements are already reflected in the day-to-day operation of the US tax system.

## **Capital Export Neutrality and Capital Import Neutrality Theories in Tax Reality**

Two international tax policy issues debated during the 1990s illustrate the sharp contest between the CEN and CIN schools. The so-called runaway plant proposal was designed to repeal deferral of corporate income taxation for US subsidiaries abroad that produce for export back into the US

market.<sup>38</sup> The proposal came straight from the CEN textbook, putting production for the US market on the same tax footing whether the goods were made in the United States or abroad. But, as CIN advocates pointed out, foreign firms also produced for the US market, and they were not taxed currently—or possibly at all—if they exported to the United States from a low-tax or zero-tax location. Hence the CIN school argued that low-tax operations of US subsidiaries should not be taxed at the US corporate rate, because they would then be put at a competitive disadvantage to foreign firms.

The problem raised by CIN logic, of course, was that purely domestic US companies also competed with lightly taxed foreign producers that exported into the US market. Further, other US companies were exporters and competed with the same lightly taxed foreign firms in global markets. Where could the line be drawn? Did CIN ultimately require tax exemption for all export and import-competing activities in the United States, as well as foreign investment? In short, was CIN logic the first step on the road to abolishing the corporate tax? Many CIN proponents would welcome this outcome: They argued that reducing corporate tax rates brought about by competition to attract investment was not a danger but a blessing, promoting capital formation and leading to supply-side growth.

One of the tax battles that focused attention on CEN and CIN theories—and which continues today—involved the so-called hybrid-branch proposed regulations issued in 1999.<sup>39</sup> The regulations were designed to limit cross-border payments by foreign subsidiaries of US-based MNEs that would shift foreign-source income from high-tax into low-tax jurisdictions, reducing foreign taxes while retaining deferral of US taxation of the income.<sup>40</sup>

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38. In the last days of the 106th Congress (1999), Senator Byron Dorgan (D-ND) attempted to have a runaway plant legislative proposal (S 1597) attached to the funding bills then being considered in Congress. Dorgan's proposal would have eliminated deferral for the profits of CFCs attributable to the manufacture abroad and import of products into the US market. The Senate voted down his proposal. Previously, a similar proposal was presented to the US Congress by the Joint Committee on Taxation (JCT) and was criticized by the American Bar Association (1989).

39. See Proposed Regulation section 1.954-2(a)(5) NPRM REG-113909-98, July 13, 1999, issued pursuant to Notice 98-11. The proposed regulations provide a moratorium on their application until five years after they are finalized, and they replace temporary regulations that were issued on March 23, 1998 in TD 8767 (63 FR 14669 (March 26, 1998)). As of July 2007, the proposed regulations were still pending. See Holland (2005).

40. The typical situation addressed by the proposed regulations involves a CFC that carries on business activity in high-tax foreign jurisdiction A and maintains a branch in zero-tax foreign jurisdiction B. Under section 301.7701 regulations (the so-called check-the-box regulations), the branch located in jurisdiction B is classified as a fiscally transparent entity for

To the Treasury Department, hybrid-branch arrangements tilted the balance struck by the Revenue Act of 1962 against CEN. Under this balance, Congress asserted CEN rules—that is, to end deferral entirely—for passive (or mobile) income that could be shifted easily among tax jurisdictions.

On the other hand, Congress was not ready to end deferral for active income, which is not easily shifted. Congress agreed that location decisions regarding active income were driven mainly by nontax business considerations, and it recognized the need to maintain active US business operations abroad on an equal tax footing with other firms doing businesses in the same country. In other words, it sought to maintain CIN with respect to such income. The proposed regulations aimed to curb the hybrid-branch arrangements as a mechanism for moving active business income from a high-tax foreign jurisdiction to a low-tax foreign jurisdiction through cross-border payments and thus upset the equilibrium achieved by the Revenue Act of 1962.<sup>41</sup>

Opposing the proposed regulations, the CIN school argued that using hybrid branches and other mechanisms to avoid foreign taxation did not justify current taxation of foreign income earned by US-based MNEs because foreign-based MNEs used similar techniques to reduce their own tax burden. In other words, the proposed regulations would hamper the ability of US-based MNEs to compete with their foreign-based rivals. Further, the CIN school invoked US revenue interests: CEN theory hardly justified forcing US taxpayers to pay more foreign taxes and thus claim more foreign tax credits at the expense of the US Treasury. Finally, the CIN school argued, once Congress had chosen to retain deferral for a jurisdiction that imposed a low tax on active business income, it should be indifferent as to how the active business income is earned.

For the time being, the CIN school has succeeded in delaying final regulations, but the debate has not ended. The CEN school contends that the hybrid-branch arrangements operate as a tax subsidy that encourages US-based MNEs to shift income into low-tax jurisdictions more than ever

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US federal tax purposes, though it is characterized as a separate entity for foreign tax purposes. The branch office in jurisdiction B lends funds to the CFC in jurisdiction A, and the interest payments paid by the CFC to the branch reduces the taxable income of the CFC in jurisdiction A for foreign-tax purposes. However, the interest payments do not attract tax in jurisdiction B. From a US federal tax perspective, under current law, the cross-border loan from jurisdiction B to jurisdiction A does not subject the branch in jurisdiction B to US tax, as the interest payments from the CFC in jurisdiction A to the branch in jurisdiction B are characterized as an interbranch fund remittance for US federal tax purposes, not as passive income.

41. The proposed regulations provide that the branch and the CFC would be treated as separate corporations for subpart F purposes, with the result that the regulations would treat certain payments made between a hybrid branch and a CFC as subpart F income, and thus currently taxed by the United States without the benefit of deferral.

through paper transactions designed purely for tax reasons. Indirectly such arrangements encourage capital to leave the United States for equally high-tax jurisdictions that also condone a hybrid-branch strategy. For the CEN school, any tax-induced shift in the allocation of resources is bad from an efficiency standpoint, whether the culprit is US or foreign taxes.<sup>42</sup>

## Capital Ownership Neutrality

In contrast to the three classic schools, which focus on allocating capital among alternative locations, Desai and Hines (2004) advocate a new concept, “ownership neutrality,” which focuses on global patterns of control by competing firms. Desai and Hines observe that different corporate control groups can extract different levels of productivity and profitability from the same amount of labor and physical capital, owing to differences in intangible assets such as management, engineering and distribution skills, trade names, copyrights, and patents. In an ideal world, national tax policies should not prevent the most adept firm from controlling a given bundle of labor and capital. In practice, however, national tax policies interfere with global efficiency.

Desai and Hines derive two tax policy implications from their work. One scenario, called capital ownership neutrality (CON), would result if all major home countries subjected their MNEs to the same tax on foreign investment. This is a radical prescription, calling for worldwide uniformity in business tax systems with respect to foreign-source income.<sup>43</sup>

The alternative scenario—labeled national ownership neutrality (NON)—would result if US-based MNEs, upon establishing or acquiring a foreign subsidiary, faced the same tax burden as MNEs based in the most tax-friendly home country. The NON scenario could be achieved through unilateral US reform simply by adopting a territorial system no matter what other countries do. As a companion feature, the US tax code then would need to define exempt foreign-source income in a manner similar to that of tax-friendly countries, such as the Netherlands. Whereas CON is a version of CEN modified to emphasize owner-

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42. According to the CIN school, the United States should be indifferent to avoiding foreign taxes due to a shift in resources from one foreign country to another (see Graetz 2001).

43. The worldwide uniform approach should apply the same tax rate to corporate income earned abroad, define foreign-source income the same way no matter which country serves as the home base, and offer the same method for avoiding double taxation—either the foreign tax credit approach or the exemption (territorial) approach.

ship rather than investment flows, NON is a territorial system, akin to the CIN doctrine.<sup>44</sup>

Grubert (2005) criticizes the CON/NON analysis. Desai and Hines contend that investment abroad does not necessarily reduce investment at home; Grubert argues that they push this point too far, failing to account for the likelihood that a firm's location decisions affect its own future choices and the choices of other firms. With the growing importance of mobile intangible assets, firms today can take better advantage of internal economies of scale by locating production in a limited number of countries to service markets worldwide. Hence, when firm A locates a plant, say, in Ireland, it is more likely that firm A will locate future plants (or expand existing plants) in Ireland. External economies of scale may attract firms B and C to Ireland as well.

Grubert argues further that either CON or NON would give US firms a strong incentive to deploy their intangible assets overseas. This would happen because royalty payments from the foreign use of US technology would be deductible against income earned abroad but would pay US tax at a low or zero rate if the United States maintained its current source rules and either exempted royalty receipts from US taxation (as does a tax-friendly country, such as the Netherlands) or allowed excess foreign tax credits to shield royalty receipts from US taxation (the general outcome under current US tax law). Contrary to the calculations of Desai and Hines, NON would not necessarily enhance US welfare if the transfer of intangible assets abroad reduced their use domestically. For Grubert, the consequence could be a substantial drain of technology and tax revenue from the United States.<sup>45</sup>

## Revenue Considerations

The link between CIN doctrine and lower US tax revenues is not as certain as the business community might wish or the Treasury might fear, and it should not be surprising that advocacy of either CEN or CIN doctrine is strongly influenced by revenue considerations. Large business firms obviously favor lower tax payments and usually but not always the Treasury favors higher tax payments. Hence neither business advocates nor Treasury spokesmen are steadfast in favoring one doctrine over the other. The Gordian knot tying the worldwide tax system advocated by CEN

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44. When ownership and control is the prime motivation for outbound capital flows, Desai and Hines (2004) conclude that outbound investment need not reduce domestic investment. In these circumstances, the NON approach, exempting foreign income from domestic taxation, enhances the income of US citizens by facilitating global application of American expertise and know-how.

45. Desai and Hines (2004) estimate that the current corporate tax system resulted in \$50 billion in lost profits in 1999, though Grubert (2005) strongly disputes this number.

doctrine to higher US tax revenue has been loosened, and so has the connection between CIN theory and lower US tax revenue.<sup>46</sup> This is unsettling because, whatever they may proclaim, business groups, the Treasury, and the Joint Tax Committee are typically more concerned about immediate revenue consequences than their allegiance to tax doctrine.<sup>47</sup>

Grubert (2001) concluded that switching from the current worldwide foreign tax credit system to a dividend exemption (i.e., territorial) system—in other words, moving toward CIN doctrine—would actually raise US tax revenues. The magnitude of additional revenues would depend on the specific features of the new system.<sup>48</sup> Grubert assumes the following features of an exemption system in his analysis:<sup>49</sup>

- Active foreign income would be exempt from US taxation, and the foreign tax credit associated with that income would be eliminated.
- Royalties and interest paid to the US parent company would be taxed, allowing for deductible expenses in the host country.
- Passive income of CFCs would be taxed on a current basis.
- A portion of the parent company's overhead expenses, such as interest, would be allocated to exempt foreign income and disallowed as a deduction from US income.
- RD&E expenses would remain fully deductible in the United States.

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46. To be sure, the Holy Grail of CEN advocates is to eliminate deferral, but for reasons spelled out in chapters 5 and 6, this is neither a wise objective for the United States nor is it politically feasible. Eliminating deferral would, for a time, increase US tax collected on the future earnings of foreign corporate subsidiaries, but within a decade corporate structures would be reshaped to reduce the tax impact (a massive Laffer curve effect). Moreover, it is unlikely that repealing deferral on future earnings would be legislated in a way that also taxed past accumulated offshore income. In an important precedent, when the DISC was repealed in 1985, deferred taxes were permanently forgiven. Likewise, the Homeland Investment Act (HR 767), enacted as part of the AJCA, allowed a partial tax holiday for 2005 on repatriation of accumulated offshore income. In light of such precedents, the possible taxation of past offshore income seems remote.

47. Earlier commentators saw the debate as inherently political, associating CEN theory with the Democratic Party and prolabor forces and CIN theory with the Republican Party and probusiness groups (Hariton 2001). Obviously the ties between tax doctrine and party affiliation are much weaker today.

48. Moreover, Grubert (2001) characterized his calculation as a static revenue estimate, as opposed to an estimate that reflects behavioral change. His territorial system echoes a proposal offered in the first edition of this study (Hufbauer 1992).

49. The features of Grubert's baseline exemption system reflect the foreign tax systems of Germany and Canada. Technically, Germany grants its companies a participation exemption for operations in most countries. Dividends from foreign subsidiaries and the earnings of overseas branch operations are exempt from German tax; at the same time, foreign tax credits are not permitted for foreign taxes paid on this income.

- Active foreign losses would not offset domestic taxable income.
- Income from US exports would be fully taxable (we find this feature to be least appealing).

Grubert's analysis suggests that an exemption system that includes all of the features listed above would raise US corporate income tax revenues by up to \$9 billion annually. Grubert attributes the revenue increase to two main aspects:

- *Elimination of cross crediting that currently shields royalties, export income, and interest income from US tax.*<sup>50</sup> This revenue increase is expected because many US companies are now in an excess credit position for dividends received from foreign subsidiaries and branch earnings.<sup>51</sup> In an excess credit situation, companies pay more than enough foreign tax to offset all US tax on all foreign dividends and branch earnings. These corporations do not pay US tax on such income under current law or the proposed exemption system. Granting an exemption on all of this income therefore does not cost the US government any revenue or save the multinationals any tax.

However, granting an exemption on dividends and branch earnings alone would raise US tax revenues: Other international income streams—royalties, interest, and export earnings—are often not highly taxed abroad, thanks to provisions in bilateral tax treaties. Under current rules, US companies in an excess-credit position do not pay US tax on this income because foreign tax credits from highly taxed dividends and branch earnings are available to satisfy the US tax liability on royalties, interest, and export earnings through “cross crediting.” The proposed exemption system would eliminate most of the foreign tax credits,<sup>52</sup> and parent companies would end up paying

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50. Eliminating cross crediting applies only to foreign income in the general-limitation income basket (see appendix A2), a category that corresponds closely to active income. It assumes that, as in Germany, other categories of foreign income are not eligible for the exemption and hence are eligible for the foreign tax credit for both direct and indirect taxes (i.e., withholding taxes and deemed-paid taxes).

51. MNEs base their calculations of foreign tax credits and limits on the combined repatriated income of all of the foreign operations in a basket. The calculations may place a corporation in either an excess-credit or excess-limit position. Companies in excess credit—those with creditable foreign taxes in excess of their limitation—pay no residual US tax. Under current law, MNEs may use these excess credits to offset US taxes on interest and royalty income from abroad and on income from export sales (half of export profit can be classified as foreign-source income). Companies in an excess-limit position—those with fewer foreign taxes to credit than the tentative US tax on the foreign income—must pay a residual US tax.

52. Under the German system, a foreign tax credit is allowed for withholding taxes on royalties, interest, and service fees only. The same rule would apply in Grubert's baseline system.

US tax on these other forms of foreign income unless they too were exempt from US taxation.<sup>53</sup>

- *Allocation of overhead deductions to exempt foreign income will increase the US tax liabilities of all parent corporations, regardless of their foreign tax credit position.* Allocation of overhead expenses is important under both the current system and the proposed exemption system. The nature of the allocation issue differs somewhat between the systems. Under current law, allocating overhead expenses affects US tax liability only through the foreign tax credit limitation. US-based MNEs that have large excess-limit positions (and thus pay residual US tax on their foreign-source income) are not affected by a marginally greater allocation of expenses to foreign income.<sup>54</sup>

However, for US-based MNEs that are near the line between an excess-limit and an excess-credit position, the allocation of expenses can matter. A greater allocation of expense to foreign-source income can push the firm into an excess-credit position, thereby denying the benefit of a portion of the firm's foreign tax payments.<sup>55</sup>

Under Grubert's exemption system, US-based MNEs in an excess-limit position would be affected because a larger allocation of overhead expenses to foreign-dividend income will reduce the expenses that could be claimed as a current US deduction. As a general rule, the US tax system does not allow deductions for expenses attributed to exempt income, such as interest on municipal bonds.<sup>56</sup>

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53. One may ask whether US corporations, working under these rules, would order their subsidiaries to stop paying royalties back to the United States in this situation. Under transfer pricing regulations, US corporations are required to record royalty income if they allow a subsidiary to use an intangible asset, such as a trademark or patent. The practical question is how to devise methods for determining the right transfer price. This is difficult in any case because of the practical difficulties in finding comparable transactions between unrelated parties in intangible assets, but a dividend exemption system would require more surveillance of corporate transfer pricing practices, as royalty income not paid, and therefore not remitted to the United States, would escape US taxation altogether. Germany has faced the same problem, as it does not exempt foreign royalties and fees from German taxation. Possibly US authorities could learn from German enforcement techniques.

54. Allocating expenses to foreign-source income does not affect their deductibility in calculating US tax liability. However, it affects the applicable foreign tax credit limit (i.e., the maximum amount of foreign tax that can be credited against US tax).

55. See the discussion of this issue in JCT (2003a).

56. The relevant law is IRC section 265. The disallowed expense can, however, be capitalized and claimed as an expense in the future if the exempt asset is sold and the capital gain is subject to US taxation.

## The Future Debate

Apart from strict revenue considerations, recent developments have stimulated fresh debate over the merits of territorial exemption. One development flows from the WTO decision to reject the FSC in 1997 and the successor ETI in 2001. The WTO Appellate Body held that the FSC/ETI regimes amounted to prohibited export subsidies and had to be repealed (see appendix A4).<sup>57</sup> These adverse WTO decisions inspired legislative efforts to offset the additional tax burden (Hufbauer 2002).<sup>58</sup> The end result was the American Jobs Creation Act of 2004, which phases out the FSC/ETI regimes by 2007.<sup>59</sup> In return, the bill gradually lowered the corporate tax rate on “manufacturing” firms (broadly defined) from 35 to 32 percent (in 2010), allowed a one-year partial tax holiday for the repatriation of dividends from foreign subsidiaries, and made other probusiness changes with a CIN flavor. The one-year partial tax holiday stimulated some debate over the merits of a permanent territorial system for “active” foreign income.

Another recent development relates to tax-driven expatriation of US corporations (so-called corporate inversion). Under an inversion, a new foreign corporation, typically located in a low-tax or no-tax country, is created to replace the existing US parent corporation of an MNE (see appendix A5); see Hufbauer and Assa (2003). The AJCA penalized inversion transactions that occurred after March 2003 (Tuerff et al. 2004). Meanwhile, the inversion phenomenon spurred calls to adopt a territorial system to reduce the incentive for inversion transactions.

As a third development, evidence accumulated during the 1990s showed that the actual US tax system, with its combination of deferral and cross crediting of foreign taxes, is very similar in bottom-line tax collections to an exemption system. The effective tax rate on foreign-source

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57. Even with the FSC, the US tax system placed a heavier burden on the traded goods and services sector of the US economy compared with the tax systems in most other major trading nations. Tax systems elsewhere emphasize value added taxes and similar broad-based consumption taxes (such as the Canadian goods and services tax) that are adjusted at the border (i.e., imposed on imports and exempted or rebated on exports).

58. Other features of the US tax system still work as export incentives. Most important is the export source rule (see appendix A4) that allows US firms to attribute roughly half of their export profits to foreign sources of income and thereby take advantage of any excess foreign tax credits generated by other business activity abroad. The WTO did not challenge the export source rule.

59. The official estimate claims the AJCA raises revenue after 2007 to make the bill revenue neutral over the 10-year period 2005 to 2014 (JCT 2004). According to George Yin (2004), chief of staff for the Joint Committee on Taxation, repeal of the FSC/ETI regime will raise \$50 billion of revenue over 10 years, other revenue raising provisions will yield \$70 billion, while the tax relief provisions will cost about \$120 billion over 10 years.

nonfinancial business income of US multinationals is extremely low—only a few percentage points compared with the zero-tax rate of an exemption system. Thus the current US tax system, though commonly associated with CEN, is in reality very similar in its revenue effects to a tax system based on CIN or NON theory. However, the current US system contains perverse incentives, discussed elsewhere in this book, and is significantly more complex and harder to administer than the territorial systems that other countries use.<sup>60</sup>

A fourth and final development is that international flows of portfolio capital have drained the traditional CEN prescription for worldwide efficiency of its relevance to FDI. To a large extent, portfolio managers and not MNEs now decide how capital is allocated among national economies.

Starting with the above propositions, chapter 4 takes up the taxation of portfolio income. Chapter 5 analyzes the place of multinationals in the world economy, emphasizing the advantages to the United States of being the home base for global corporate groups. In chapter 6, we advocate our own version of a territorial approach, assuming that the United States retains the corporate income tax.

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60. Grubert and Mutti (2001, 3) contend that shifting to a territorial system would realize efficiency gains because “US multinational corporations would not have to devise elaborate schemes for restricting dividend repatriations to minimize their US tax. Nor would US multinationals have to forego investment opportunities in the United States for the sake of tax avoidance. In addition, by dispensing with the need for credits for taxes paid to foreign host governments, a dividend exemption system would eliminate the complex calculations companies must take in claiming those credits against US tax on repatriated dividends. A dividend exemption system would also simplify and rationalize the taxation of US exports, as well as royalties received from abroad.”