U.S. Tax Policy Towards Foreign Operations Hamper International Competitiveness of U.S. Multinationals

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Abstract

This article compares U.S. taxation of foreign source income along with domestic tax incentives with that of other major industrialized nations such as the U.K., Canada, Germany, France, and Japan. The paper points out that U.S. tax policy towards the profitability and expansion of foreign operations ignores the economic realities of the 1990s. In addition, revenue-raising concerns of U.S. tax policy appear to override international competitiveness considerations. The article calls on U.S. tax policymakers to (1) find ways to establish U.S. business presence in the emerging markets of Europe and the Pacific Rim; (2) reverse the declining trend in the U.S. share of exports of technology intensive products; (3) find ways to meaningfully lower the cost of capital to U.S. businesses; and (4) find practical solutions for both the budget and trade deficit.

Introduction

This article evaluates and compares U.S. tax policy towards foreign operations with respect to the ability of U.S. businesses to take advantage of business opportunities in emerging foreign markets. For this purpose, the article compares U.S. taxation of foreign source income and domestic tax incentives with that of other major industrialized nations such as the U.K., Canada, Germany, France, and Japan.¹ The basic postulate of the paper is that U.S. tax policy towards the profitability and expansion of foreign operations ignores the economic realities of the 1990s. The paper points out that revenue-raising concerns appear to override international competitiveness considerations.

Economic Realities of the 1990's

In the decade of the 1990s, domestic standard of living and world influence will be determined more by economic factors than by the inventory of military arsenal. The current economic arena is one in which increasing amounts of exports will be handled through foreign-based affiliates. Indeed, the establishment of foreign presence in the emerging markets of Eastern Europe and the Pacific Rim can give companies an important "beachhead" from which to market goods and services. In this regard, the U.S. tax system can be used to aid U.S. multinationals in taking advantage of emerging markets.

Currently, the U.S. has a greater degree of foreign presence than other major trading partners such as Japan and Germany (U.S. Department of Commerce, 1989). Both Japan and Germany have been playing catch-up with the U.S. in establishing business presence in foreign markets which they have traditionally served by exports. In the early 1960s, well below 50 percent of American exports were handled through foreign-based U.S. affiliates. However, by 1986 over 72 percent of such exports were handled through foreign-based U.S. companies (Whichard, 1989). Notwithstanding, the U.S. foreign presence advantage is being offset by protectionist U.S. tax policy with respect to foreign operations.

Research has shown that national governments can influence global market share of world trade by using factors such as: (1) protective tariffs, (2) export cartels, (3) taxation of foreign source income, and (4) export subsidies (Brander and Spencer, 1983). However, the General Agreement on Tariffs and Trade (GATT) precludes member countries from using direct methods of influencing global market share of goods and services.

For example, the European Community countries made a formal complaint to the GATT Council regarding export enhancing tax incentives under the Domestic International Sales Corporation (DISC) provisions.² EC members charged that the DISC offered a direct tax

subsidy which is illegal under Article Sixteen of the GATT. The U.S. responded by stating that the value added tax and the territorial tax system employed by EC members are also export subsidies, albeit indirect ones. The U.S. later came to an understanding with the GATT Council by agreeing to modify the DISC provisions. The DISC was replaced with the Foreign Sales Corporation (FSC) provisions in 1984.

Given GATT stipulations regarding direct incentives, governmental actions to stimulate exports or to take advantage of business abroad are limited primarily to indirect methods such as influencing the profitability of foreign operations and to offering tax incentives to stimulate domestic technological innovation and capital spending. These measures are used by the other major industrialized nations.

Shortcomings of U.S. Tax Policy Towards Foreign Operations

Current U.S. tax policy towards the foreign operations of its multinationals has two significant shortcomings: (1) the imposition of protectionist tax provisions on foreign source income, and (2) inadequate tax incentives to meaningfully encourage economic activity such as capital spending and technological innovation.

The protectionist tax provisions result primarily from holdover legislation from the early 1960s and from revenue raising concerns. A major objective of the Revenue Act of 1962 (Public Law 87-834) was to force U.S. multinationals to repatriate foreign earnings rather than reinvesting such funds abroad. Proponents of protectionist provisions under the Act, for example, charged that American tax policy contributed to the "building up of South Italy rather than South Carolina and West Germany rather than West Virginia".³ While many of the provisions under the Revenue Act may have been timely in the 1960s, they appear to be counterproductive in the economic environment of the 1990s.

On the other hand, the failure to offer more generous tax incentives for technological innovation and capital spending may be driven by concerns regarding revenue costs to the U.S. Treasury. The current budget deficit makes it difficult for the U.S. Congress to offer new or enhanced tax incentives without consideration to the impact on the budget deficit. The protectionist provisions under the U.S. Internal Revenue Code include: (1) the early taxation of income from transactions between related foreign based U.S. owned entities (IRC Sections 951-964); (2) the determination of creditable foreign taxes (IRC Sections 901 and 902); and (3) the burdensome tax cost on foreign transfers of American technology (IRC Section 367(d)).

Early Taxation of Unrepatriated Foreign Earnings

IRC Sections 951-959 classify certain passive types of foreign earnings of U.S. controlled foreign corporations (CFC) as Subpart F earnings. Subpart F earnings are taxable immediately in the U.S. even though not repatriated. A CFC is a foreign based corporation with greater than 80 percent of its stock owned by U.S. persons. Subpart F income includes passive-types of foreign earnings and income arising from transactions between related foreign based U.S. affiliates located in different foreign countries. In addition, the foreign earnings of Passive Foreign Investment Companies (PFIC) are taxed immediately in the U.S. even though not repatriated. Under IRC Sections 1291-1296, the PFIC provisions apply when a significant portion of income (greater than 75 percent) results from passive types of activities and/or a significant portion of total assets (greater than 50 percent) are invested in passive types of assets.

The Revenue Act of 1962 instituted the Subpart F provisions primarily to encourage the repatriation of foreign earnings of U.S. controlled foreign corporations. In this way, the U.S. Treasury is able to tax such earnings before repatriation. While the Subpart F provisions may indeed encourage early repatriation of foreign earnings, it can produce perverse results and require significant effort in applying the provisions.

Take, for example, a U.S. company with an affiliate in Brazil. If the Brazilian affiliate holds working capital in a depository institution, significant interest income may result because of hyper-inflationary economic conditions. Such interest income will likely be treated as Subpart F income to a CFC and will be taxed immediately in the United States.⁴ However, foreign currency losses with respect to the same Brazilian subsidiary cannot be used to offset such interest income. Instead, associated foreign currency losses must be allocated against various categories of income including the interest income. Indeed, in the extreme case, the interest income generated under hyper-inflationary conditions may trigger the PFIC provisions under IRC Sections 1291-1296, thereby subjecting both passive and business income to immediate taxation in the United States.

Similar transactions by foreign counterparts from countries such as West Germany, Canada, France, Japan, and the U.K. are able to avoid such adverse consequences. Unlike the U.S. and Japan, France, the U.K., and Germany use the territorial type tax system and foreign earnings are rarely taxed until repatriation to the home country. Both the U.S. and Japan use the worldwide tax system but Japan does not target unrepatriated foreign earnings to the extent the U.S. does. For example, Japan does not levy immediate taxation on intercompany profits on sales of goods between affiliates in different countries. In this regard, U.S. multinational-

TABLE 1
RELATIVE STATUTORY TAX RATES

	<u>United States</u>	<u>United Kingdom</u>	<u>Japan</u>	<u>West Germany</u>	<u>Canada</u>	<u>France</u>
Max. Federal Income Tax Rate on Undistributed Earnings	34%	35%	37.5%	50% ^a	39% ^b	39% ^c
Average State, Local & Municipal Tax Rate	5.3%	N/A	19.5%	7.5%	8.5%	18% ^d
Combined Statutory Rate	39.3%	35%	58%	57.5%	47.5%	57.0%
Max. Value Added Tax Rate	None	15%	None	14%	7.0%	18.6% ^e

* Table 1 consists primarily of the statutory tax rates and does not take into account the interaction of Federal and state and local taxes. Withholding taxes on dividends vary widely based on payor and payee. As such, the rates above ignore withholding. The Canadian value added tax is a gross sales tax on goods and services (Commerce Clearing House, 1991).

- a. This tax rate applies to distributions to shareholders. Shareholders get a tax credit for dividends.
- b. The nominal tax rate is 45.5 percent but the rate is reduced to 39 percent on income arising from Canadian manufacturing and processing. In both cases, a 10 percent abatement is allowed for provincial taxes.
- c. A special reduced rate applies to certain companies constructing residential homes.
- d. The rate is 18 percent on fixed assets and salaries.
- e. The rate varies from 2.1 to 33 1/3 percent but the normal rate is 18.6 percent.

als are forced to pay home country taxes on unrepatriated foreign earnings to a greater extent than the countries examined herein.

Effective Tax Burden on Foreign Source Income

U.S. tax laws impose a number of provisions on the taxation of foreign source income of its multinationals that raise the effective U.S. tax burden on such earnings above that of the major trading partners. Table 1 shows that the U.S. has a lower statutory income tax rate than most of the major industrialized nations compared herein. As such, it may appear that the offshore earnings (foreign source) is taxed at a lower rate than that of the other major industrialized nations. However, the U.S. imposes several limits on the ability of U.S. multinationals to credit taxes paid abroad on the foreign earnings included in U.S. taxable income.

Under U.S. tax laws, the amount of foreign taxes used to offset U.S. taxes on the related offshore earnings is limited primarily because: (1) unlike the trading part-

ners, U.S. tax laws require the allocation of U.S. incurred expenses against foreign source income in determining creditable foreign taxes and (2) unlike the trading partners, U.S. tax laws require the segregation of foreign source income into various baskets in determining the creditable foreign taxes.⁵

U.S. incurred expenses such as R&D outlays, interest expenses, and stewardship expenses must be allocated between foreign source and U.S. income in calculating the creditable foreign taxes. The allocation reduces foreign source earnings and increases U.S. source earnings by the amount of expense allocated. Creditable foreign taxes are reduced in the current period and such taxes may expire before their use. Indeed, as foreign operations grow relative to U.S. operations, the effect of

the mandatory allocation of U.S. incurred expenses against offshore earnings becomes increasingly significant.

TRA '86 revised the way creditable foreign taxes are determined. Foreign source income is now segregated into nine categories based on type of income. The consequence is that the foreign tax rates on income from different categories cannot be blended to increase creditable foreign taxes. The Japanese and the West German foreign tax credit limitation systems do not use the income basket approach. Unlike the U.S. and Japan, the West German system uses the per country limitation rather than the world-wide system.

The income basket approach used by the U.S. is more punitive than both the West German and the Japanese systems. Under the per country approach used by West Germany, opportunities exist to control where (country) income is reported. Therefore, the ability to control where income will be reported will enable blending of income within country and thereby increase creditable

foreign taxes. Likewise, under the Japanese system, different types of income can be blended (without regard to source) to increase the creditable foreign taxes.⁶ However, the income basket approach used by the U.S. does not allow the blending of different types (baskets) of income.

In the world's rapidly emerging markets, new business opportunities may require debt financing to build new factories or to purchase new equipment. Rational economic behavior would dictate borrowing the needed funds in the country with the lowest interest rate. Under current U.S. tax laws, if the needed funds are borrowed abroad, interest charges can be used to fully offset foreign source income in determining the creditable foreign taxes in the current year. However, if the funds are borrowed in the U.S., only part of the interest charges can be used to offset foreign source income for purposes of the foreign tax credit. Similar transactions by foreign counterparts escape these perverse results.

For each dollar of global sales, U.S. multinationals have the highest proportion of such sales sourced abroad and, therefore, are most affected by restrictive foreign tax credit limitations. Approximately 72 percent of U.S. exports are internal transfers between U.S. parent corporations and their foreign affiliates (Whitchard, 1989, and U.S. Department of Commerce, 1989).

The trading partners such as Japan and West Germany are playing "catch-up" to establish foreign presence (U.S. Department of Commerce, 1989).⁷ Foreign presence is often critical for capturing or increasing market share and for establishing service businesses, such as, banks and insurance companies. Differences in the tax burden on foreign source income are likely to affect the ability to take advantage of business opportunities in emerging markets or to maintain or increase market share in existing markets.

Prudent U.S. policy would dictate imposing an effective tax burden on foreign source income no higher than that of other major industrialized nations such as Japan and West Germany. However, the limitations on determining creditable foreign taxes discussed above raise the effective tax burden on the foreign source income of U.S. companies relative to their foreign counterparts. One way to allow U.S. companies to operate on a level playing field with their foreign counterparts is to eliminate both the allocation of U.S. expenses against foreign source income and the segregation of foreign source income by type in calculating creditable foreign taxes.

Foreign Transfers of U.S. Technology

Current U.S. tax laws provide little incentive for the exploitation of U.S. technology in the emerging markets

of the world. Many of the emerging markets of Eastern Europe and the Pacific Rim have physical facilities for new plants and an experienced work-force, but need hard currency and process technologies. The ability of U.S. companies to efficiently deploy American developed technology abroad would help pay for the cost of developing the technology and for increases in the level of technological capital in future years.

U.S. tax policy regarding foreign transfers of American technology impedes the competitiveness of U.S. firms in two important respects: (1) front-end taxation of U.S. technology in foreign joint ventures, and (2) Internal Revenue Service's (IRS) assessment of exorbitant royalties with little regard for economic uncertainties.

Many business opportunities in the emerging markets of the world are in the form of joint venture arrangements. Under current U.S. tax laws, technology transfers to foreign joint ventures are treated as a sale of the technology at the fair market value. In many instances, the joint venture takes years to produce any profit. If the joint venture becomes successful, the IRS is empowered to levy a tax on the increased value of technology.⁸ Unlike U.S. companies, German, Japanese, French, and British firms can consummate similar joint venture opportunities without a front-end tax cost.

Under IRC Sections 367(d) and 936(h), U.S. shareholders must annually report U.S. source income attributable to foreign transfers of U.S. technology. Traditionally, U.S. owned firms have deferred taxes attributable to U.S. developed patents by transferring the technology to either their foreign affiliates or a U.S. possession's corporation under IRC Section 351.⁹ However, IRC Section 367(d) treats such transfers as a sale of the technology. The sales proceeds are deemed to be received annually commensurate with the use and productivity of the technology.¹⁰

As justification for the changes, Senate Report No. 494 of the 97th Congress pointed out that U.S. owned entities sometimes obtained an R&D credit on expenditures associated with U.S. developed patents and then shifted a significant portion of the income attributable to such patents abroad.¹¹ The result is the deferral or avoidance of U.S. taxes on the income even though the U.S. Treasury subsidized the technology.

This legislation eliminated the perceived problem but the tax imposed on targeted transfers put U.S. multinationals at a competitive disadvantage as compared with their foreign counterparts. In some situations, technology transfers may trigger a tax before revenues are generated with which to pay the tax (IRC Section 367(d)). In addition, the legislative requirements apply to technology transfers whether or not the R&D credit

was obtained. The IRS currently monitors such transfers as a prelude to increasing the previously agreed upon royalty rates thereby resulting in additional compliance burdens on U.S. companies.

Inadequate Tax Incentives for R&D and Capital Spending

American firms face higher capital costs for both debt and equity capital; as a consequence, U.S. firms may be forced to avoid expensive, long-term and risky investment projects in favor of short-term projects with little risk (Garner, 1988; Mervosh, 1987 and McCallum and Vasilash, 1989). International comparative statistics show that the U.S. lags significantly behind a number of the major trading partners in R&D spending as a percentage of gross national product and in fixed capital spending per person (Hall, 1986; Chirinko and Feldstein, 1987 and Liebttag, 1987).

Figure 1 shows the weighted average cost of capital for Japan, United Kingdom, West Germany, and the United States (Center for Economic Policy Research, 1986 and Richman, 1989). As reflected therein, the U.S. has the highest cost of capital of the countries examined. Indeed, the cost of capital in the U.S. is almost twice the cost of capital in Japan. The cost of capital imbalance is likely to put U.S. companies at a competitive disadvantage with respect to break-even for long-term and risky projects. A recent comparison between U.S. and Japanese based firms show that investment projects by U.S. firms must break-even on average in seven years while Japanese companies may take up to ten years to achieve break-even (Center for Economic Policy Research, 1986, and Richman, 1989). Research has shown that the incremental returns from R&D and from the upgrading of capital equipment take in excess of five years to materialize (McCallum and Vasilash, 1989, Chirinko and Feldstein, 1987, and Liebttag, 1987).

As a result, the financing of long-term projects such as capital equipment and R&D is made increasingly difficult and may be avoided as the cost of capital rises (Hall, 1986). A likely consequence is that foreign counterparts will dominate in industries or products that are sensitive to production efficiencies or technological innovation. Foreign counterparts in countries with lower capital costs are allowed a competitive advantage from enhanced production efficiency resulting from superior technology and more efficient plant and equipment.

With respect to R&D, Figure 2 shows that while the Japanese have significantly increased their non defense related R&D since 1978, the U.S. has not increased its spending since 1972 except for a slight increase between 1979 and 1981 (National Science Foundation, 1989). Figure 2 also shows that West Germany has increased nondefense R&D from a low of 1.9 percent of gross national product (GNP) in 1973 to a high of 2.6 percent in 1985.

With respect to capital spending, of the six major industrialized nations (Japan, United Kingdom, Canada, West Germany, France, and the United States) the U.S. ranks last in private fixed capital spending per person (Data Resources, Inc.). In particular, Figure 3 shows

that Japan ranks first with 29 percent of GNP going for capital spending; the U.S. ranks last with a mere 15.8 percent of GNP invested in capital spending. In this regard, U.S. productivity and export competitiveness could suffer for similar levels of capital utilization.

Federal tax incentives would be helpful in lowering the after-tax cost and hence the net present value of

FIGURE 2

ESTIMATED NON DEFENSE R&D EXPENDITURES
AS A PERCENTAGE OF GNP

Source: National Science Foundation, *International Science and Technology Data Update: 1988*. (NSF 80-307), Washington, D.C., 1989.

long-term and expensive investment projects such as R&D and the upgrading of plant and equipment. Federal tax incentives in the form of the R&D credit, the investment tax credit, and the accelerated capital recovery to reduce the after-tax cost may help U.S. multinationals increase R&D activity and the upgrading of plant and equipment. However, in recent years, business incentives such as the investment tax credit have been eliminated, the effective rate of R&D incentives has been reduced, and the tax shield afforded by capital equipment has been reduced.¹² These incentives have been reduced or eliminated even in light of declining U.S. productivity growth and export competitiveness.

Policy Recommendations

To be competitive in the economic environment of the 1990s, U.S. tax policy must have both a neutral and a

non-neutral dimension. The neutral dimension means refraining from imposing overly burdensome tax and compliance burdens on the foreign source income of U.S. companies. In particular, provisions such as: (1) the early taxation of income from transactions between related foreign based U.S. entities, (2) the various allocations of overheads that result in the loss of foreign tax credits, and (3) the tax burden on foreign transfers of American technology should be addressed. These provisions should, at best, be repealed and, at worst, be kept in check. Failure to do so raises the cost of doing business to U.S. companies when compared to their foreign counterparts.

The non-neutral dimension means offering meaningful tax incentives to encourage investment alternatives, such as, research and development and capital spending. Indeed, our current twin budget and trade deficits and the declining global market share of technology intensive products are symptoms of a crisis in the making.

Finally, the U.S. international trade position faces many challenges as the new economic order of the 1990s emerge. The challenges demand that U.S. tax policy-makers: (1) find ways to establish U.S. business presence in the emerging markets of Europe and the Pacific Rim; (2) reverse the declining trend in the U.S. share of exports of technology intensive products; (3) find ways to meaningfully lower the cost of capital to U.S. businesses; and (4) find practical solutions for both the budget and trade deficit.

Footnotes

1. Italy is excluded because of the unavailability of appropriate data or tax provisions affecting foreign source income. In some cases, comparisons are made only for those countries with appropriate data or tax provisions affecting foreign source income.
2. The DISC was essentially a U.S. registered paper corporation serving as an alter ego of its U.S. related supplier or principal. The DISC was primarily meant to grant tax-deferral privileges to U.S. manufacturers who exported U.S. made goods or services to foreign countries without the help of a U.S. owned foreign affiliate. A secondary objective was to aid U.S. exporters competing with foreign exporters who operated under a territorial type system of taxation, or a value added tax system (VAT).
3. Public Law 87-834 (87th Cong. 2d Session, March 16, 1962), pp. 784-1121.
4. Taxation results only to the extent of available current or accumulated earnings and profits (undis-

FIGURE 3

COMPARISON OF CAPITAL SPENDING AMONG MAJOR INDUSTRIALIZED NATIONS (PRIVATE FIXED INVESTMENT AS A PERCENTAGE OF GNP)

Source: Data Resources Inc., 1989.

tributed earnings foreign earnings). However, exceptions are provided under I.R.C. Section 954(b).

5. Because the U.S. employs the worldwide tax system as compared to a territorial one, it allows a foreign tax credit to offset U.S. taxes on income that was subject to an income tax in a foreign jurisdiction. However, under the foreign tax credit limitations (IRC Section 902-905), creditable foreign taxes are limited to the tax that would have been levied had the income been earned in the U.S.
6. That is, income that is subject to tax rates in excess of the Japanese tax rate can be combined with income that is taxed below the Japanese rate to produce a blended rate and thereby increase the creditable foreign taxes.
7. The data shows that the U.S. share of global foreign investments fell from 47.1 percent in 1960 to 31.5 percent in 1987. The Japanese share increased from

0.7 percent to 7.5 percent and the West German share increased from 1.2 percent to 9.8 percent over the same period.

8. The Internal Revenue Service audits typically question fair market values assigned by taxpayers.
9. Generally, IRC Section 351 grants tax deferral for transactions in which persons holding 80 percent or more of the stock of a corporation transfers property to such corporation in exchange for stock of the corporation.
10. IRC Section 367(d)(2)(A)(ii). A sale of the stock received in the IRC Section 351 exchange before the end of its useful life will trigger a tax to the extent the fair market value of the technology exceeds the adjusted basis.
11. See Committee Reports accompanying IRC Section 367(d).
12. The lowering of the statutory tax rate on corporate income may have partially offset the loss of these tax incentives. However, in many cases the tax base of affected taxpayers may have increased as a result of the elimination of deferral for certain income items and the delayed deduction or outright denial of otherwise deductible expenditures.
13. Canada and France are excluded because of the unavailability of the appropriate data.

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