

Foreign Policy In Focus



Volume 3, Number 1
January 1998

Taxing Overseas Investments

Janice C. Shields, Institute for Business Research and Tax Watch

Tax policy and foreign policy intersect when tax laws have the potential to influence international relations. For example, should a country tax foreign companies operating within its borders? Should a country tax the foreign operations of domestic companies? How can countries work together to combat international tax avoidance and evasion by corporations? What, if any, should be the multilateral response to the increasing use of tax incentives to promote trade and investment?

Key Points

- Tax policy becomes foreign policy when companies operate outside their headquarters country and are subjected to tax laws of multiple jurisdictions.
- Tax havens offer permanent tax incentives to businesses; other countries may temporarily eliminate or postpone tax payments or reduce tax rates.
- Countries sign tax treaties to reduce the double taxation of international companies by both host and home countries, and also coordinate efforts to control tax avoidance and evasion efforts of multinationals.

Washington expects to collect more than \$1.5 trillion in receipts in 1998; 12% will come from corporate income taxes, 44% from individual income taxes, 36% from social insurance taxes and contributions, 4% from excise taxes, and 4% from miscellaneous sources.

Though every country claims the right to tax income originating within its borders, national philosophies regarding the taxation of foreign earnings differ. Switzerland and Argentina, for example, have adopted a "territorial" principle of taxation, taxing only income generated within their borders. The United States follows a "worldwide" principle, taxing

U.S. corporations and individuals on income earned inside and outside its national boundaries.

The worldwide principle creates the potential for double taxation of foreign income—once by the host country and again by the United States—which could discourage U.S. businesses from expanding abroad. Tax treaties between countries reduce or eliminate double taxation. Signatories to these treaties generally agree on how taxes will be imposed, shared, or otherwise eliminated on business income earned in one taxing jurisdiction by nationals of another. The U.S. currently has such treaties with 47 countries.

When the income of a U.S. corporation's foreign subsidiary is subject to both host country and U.S. taxes, the U.S. parent company may declare a tax credit or deduction on its U.S. return for income taxes paid by its

overseas subsidiaries. A credit directly reduces the amount of taxes due, while a deduction reduces the taxable income, which then is multiplied by the tax rate to determine the taxes due.

Countries eager to attract foreign investment may offer a number of tax incentives. Tax holidays grant companies relief from paying taxes for a period of time. Other forms of temporary tax inducements include reduced income tax rates, tax deferrals (which allow companies to postpone but not avoid paying taxes), and the reduction or elimination of various indirect taxes such as sales taxes.

A few countries, called tax havens, offer permanent tax inducements. The Bahamas and the Cayman Islands, for example, assess no taxes, and the British Virgin Islands and Gibraltar tax at very low rates. Some U.S. companies attempt to take advantage of tax havens by shifting (on paper) their profits to these countries and paying no taxes there, while benefiting from the "deferral principle" in U.S. tax law.

The deferral principle permits corporations to postpone U.S. taxation on the earnings of their foreign subsidiaries until that income is remitted to the U.S. parent. According to the congressional Joint Committee on Taxation (JCT), companies will cut their U.S. taxes by \$1.2 billion in 1998 by taking advantage of the deferral principle. Congress has attempted to reduce the tax avoidance benefits of shifting income to tax havens by establishing a list of types of income (such as interest revenue or shipping profits) that may not be deferred from U.S. taxation by foreign corporations that are majority-owned by U.S. shareholders.

Transnational companies (TNCs) use transfer pricing to shift income (on paper) to reduce their worldwide tax bill. By carefully setting prices on intracompany sales of products and services, TNCs attempt to locate profits in lower tax countries (including tax havens) and tax-deductible expenses in higher tax countries. Governments try to combat abuses by establishing strict documentation requirements for transfer prices and penalizing tax avoidance schemes. National tax authorities are cooperating internationally by sharing transfer pricing information.

Current U.S. tax law results in billions of dollars in intentional and unintentional tax breaks for U.S. and foreign TNCs. Tax incentives for international investors are ineffective, and taxation of domestic-only U.S. firms is inequitable. The ability of countries to establish tax law is being undermined by TNCs and multinational institutions.

According to JCT estimates, the U.S. Treasury will lose \$10 billion in revenue in 1998, due to Internal Revenue Code tax breaks for U.S.-based TNCs. For example, in addition to benefiting from the deferral principle, U.S. TNCs can exempt from U.S. taxes a portion of their income from U.S. exports as well as from leasing property outside the United States. To take advantage of this exemption, the U.S. company must set up a foreign sales corporation (FSC) under the laws of a foreign country and maintain a permanent establishment there. The JCT estimates that companies will use FSCs to cut U.S. tax bills by \$1.6 billion in 1998.

TNCs may also use transfer pricing to reduce U.S. taxable income and taxes. Estimates of the U.S. Treasury's revenue losses due to the manipulation of transfer prices by TNCs range from \$12 billion to \$50 billion. The U.S. General Accounting Office found that 236 foreign corporations with U.S. earnings were required to adjust their transfer prices by a total of \$2 billion after review by the Internal Revenue Service in 1994. The same study reported that in 1991 (the most recent year for which data were available) 73% of foreign companies filing U.S. tax returns paid no U.S. taxes.

Jurisdictions that forego tax revenue by offering tax incentives to influence foreign investment and site-selection decisions, may end up being big losers instead. For example, Volkswagen played Pennsylvania and Ohio off against each other when the company decided to open a new U.S. plant. Pennsylvania "won" after the state agreed to provide five years of local tax abatements and a number of other nontax incentives. Only half of the jobs that VW had promised were created, however, and the company ended up closing the plant in less than 10 years.

Surveys and studies of TNCs have concluded that companies' motivations for making direct foreign investments are based on five major strategic considerations. Firms are seeking: (1) markets for their products and services, (2) raw materials, (3) low-cost factors of production, such as labor, (4) knowledge, including technological and management expertise, and (5) political safety. Financial considerations, including potential tax liabilities, were found to be less important than these strategic motivations.

According to *Site Selection* magazine, quality labor, overall costs, business climate, and infrastructure are today's top site-selection factors. In fact, tax incentives can undermine the ability of governments to raise adequate revenues to pay for education, worker training

and retraining, and infrastructure improvements, which have been found to be the key criteria in business site selection. Some respondents to a World Institute survey even suggested that incentives were counterproductive when they led to unproductive and unsustainable investments in underdeveloped areas.

Elements of the U.S. tax code violate the "equity" and "neutrality" tests—principles proposing that taxpayers who are similarly situated should be similarly treated. Companies can take advantage of the deferral principle to indefinitely postpone payment of U.S. taxes on foreign, but not domestic, income. Only foreign income taxes can be credited against U.S. tax bills, i.e., used to reduce U.S. taxes due by the amount of foreign taxes paid. Other taxes, such as U.S. property taxes, are deducted from taxable income, so the benefit is much smaller. U.S. companies are subject to the alternative minimum tax, established to prevent high-income taxpayers from avoiding significant tax liabilities through the use of certain deductions, credits, and exclusions from taxable income. According to the Congressional Budget Office, a minimum tax levied on foreign-owned companies doing business in the U.S. could generate an additional \$100 million in tax revenue.

Pressure from TNCs and multinational institutions may limit the ability of governments to establish and impose tax laws. Even though research shows that tax incentives are relatively unimportant factors in investment and location decisions, TNCs may still pressure governments for favorable tax treatment. A *Wall Street Journal* exposé, for example, reported that the multinational Intel, which generated profits of more than \$5 billion in 1996, circulates the company's "ideal incentive matrix" among officials of competing locations when it announces plans to build a new plant.

Multinational institutions are increasingly interfering in decisions of national taxing authorities, too. For example, the predecessor to the FSC, the Domestic International Sales Corporation (DISC), was declared a violation of the General Agreement on Tariffs and Trade rules on incentives, because DISC rules didn't require companies to set up a foreign office. The Multilateral Agreement on Investment (MAI), which is currently being negotiated by nations of the Organization for Economic Cooperation and Development (OECD), would require countries to open up their economies to foreign investment. To control the use of tax incentives in bidding wars for investment, the MAI may attempt to restrict (by economic sector) national tax rates.

<h3>Key Problems</h3> <ul style="list-style-type: none">• Tax laws create billions of dollars in intended and unintended tax breaks for transnational corporations.• Tax incentives don't have a major impact on business decisions, but they do reduce government revenues available for important site-selection factors such as infrastructure.• Pressure from TNCs for lower taxes and interference by multilateral institutions seeking to harmonize tax laws limit national taxing sovereignty.

Tax authorities should review the intended and unintended tax breaks for wealthy U.S. and foreign TNCs that cut Treasury receipts by billions of dollars annually. Problems with the tax code should be corrected, and TNCs should be held accountable for any tax incentives they receive. Tax authorities should coordinate their efforts internationally to guarantee that TNCs pay the taxes due, but governments should maintain their tax sovereignty.

Violations of the equity and neutrality principles should be corrected. TNCs should be allowed only a deduction, not a credit, for foreign income taxes paid. Representative Bernie Sanders (I-VT) has included this proposal in his omnibus corporate welfare bill.

Deferral of payment of U.S. taxes on foreign income should not be permitted. In 1962, the Kennedy administration proposed a substantial trimming of deferral in order to reduce outflows of U.S. capital. Congress considered eliminating deferral in 1975, and President Carter proposed its repeal in 1978.

provide to the public a detailed cost-benefit analysis of each proposed tax incentive over the life of the program. The government should also have to hold hearings to receive and consider comments from the public on the cost-benefit analysis before authorizing the program. Beneficiaries of tax incentives should be required to provide annual reports showing that the company has complied with the commitments (such as job creation) that formed the basis of the cost-benefit analysis. If the government determines that the company is not complying with its commitments, the government should be able to terminate the tax incentive and assess the company for repayment of all benefits received plus interest and penalties.

Corporations that benefit from tax incentives should act as good corporate citizens by adopting and adhering to recognized codes of conduct. Principles for Global Corporate Responsibility have been established jointly by organizations in Great Britain, Canada, and the United States. These principles require that companies set forth standards governing corporate behavior and advertising and protect the environment, workers, and children.

Tax authorities should coordinate their efforts to enforce tax laws without requiring national governments to sacrifice sovereignty. The model for such a process might be the Multilateral Convention on Administrative Assistance in Tax Matters of the OECD and the Council of Europe. The intention of the convention is to link countries in an international network of cooperating tax authorities, who would exchange information in an effort to deal with tax avoidance by TNCs. Under the convention, tax authorities receiving a request for information from a foreign taxing body would carry out a local investigation. However, they would not undertake administrative measures—such as an audit of the taxpayer's books and records—if that would be at variance with the laws and administrative practices of the country requesting the information. Such an arrangement would be superior to the proposed MAI, which may impose restrictions on national tax laws in an attempt to abet, rather than regulate worldwide operations of TNCs.

Janice C. Shields, PhD, is Consumer Rights Advocate and Coordinator of the Business Accountability Project at the Institute for Business Research, Inc.

Key Recommendations

- Tax breaks should be eliminated unless experts and the public determine that the public benefits exceed the cost of reduced government revenue.
- Corporate beneficiaries of tax breaks should provide annual reports showing that they have complied with the requirements of the incentive and have acted as good corporate citizens.
- National tax authorities should share information about multinational corporations, rather than accepting restrictions by multilateral institutions on the imposition of domestic tax laws.

If deferral continues to be permitted at all, other types of income should be added to the list of income sources that cannot be deferred from taxation. Currently, profits of foreign subsidiaries of U.S. companies that manufacture products imported by the U.S. can be indefinitely deferred from U.S. taxes, even though these imports may cause U.S. job losses. For instance, in 1994 IBM reported \$11.28 billion in accumulated unremitted foreign earnings deferred from U.S. taxation, while the Department of Labor certified 1,755 U.S. IBM workers as eligible to receive trade adjustment assistance, because the company had shifted production overseas and

imported products. In the past, Senator Byron Dorgan (D-ND) has introduced bills that would add income earned from the export of products to the U.S. by subsidiaries of U.S. corporations to the list of immediately taxable types of income.

Taxing jurisdictions should place demands on TNCs, not vice versa, if tax incentives are offered. Legislation should mandate that independent experts prepare and

Foreign Policy in Focus is a joint project of the Interhemispheric Resource Center (IRC) and the Institute for Policy Studies (IPS). The project depends on sales and subscription income, individual donors, and grants from The John D. and Catherine T. MacArthur Foundation, General Service Foundation, and various church organizations. *In Focus* internships are available.

Editors
Martha Honey (IPS)
Tom Barry (IRC)

Production
Grant Moser

Communications Director
Erik Leaver (IRC)

Orders and subscription information:

Mail: PO Box 4506
Albuquerque, New Mexico 87196-4506
Phone: (505) 842-8288
Fax: (505) 246-1601
Email: resourcectr@igc.apc.org

Editorial inquiries and information:

IRC Editor	IPS Editor
Phone: (505) 388-0208	Phone: (202) 234-9382/3 ext. 232
Fax: (505) 388-0619	Fax: (202) 387-7915
Email: resourcectr@igc.apc.org	Email: ipsps@igc.apc.org

Website: <http://www.zianet.com/infocus>

Sources for More Information

Organizations

Citizens for Tax Justice

1311 L St. NW
Washington, DC 20005
Voice: (202) 626-3780
Fax: (202) 638-3486
Website: <http://www.ctj.org>
Contact: Michael P. Ettlinger

Institute for Business Research

PO Box 19793
Washington, DC 20036
Voice/Fax: (202) 387-5190
Email: jshields@igc.apc.org
Contact: Janice C. Shields

Interfaith Center for Corporate Responsibility

475 Riverside Drive, Rm. 566
New York, NY 10115
Voice: (212) 870-2928
Fax: (212) 870-2023

Organization for Economic Cooperation and Development

2001 L St. NW, Ste. 650
Washington, DC 20036-4910
Voice: (202) 822-3870
Email: daffa.contact@oecd.org
Website: <http://www.oecd.org>

Progressive Caucus

213 Cannon House Office Building
Washington, DC 20515
Voice: (202) 225-4115
Fax: (202) 225-6790
Contact: Bill Goold

Publications

Robert W. Benson, *Getting Business Off the Public Dole* (Los Angeles, CA, 1995).

Citizens for Tax Justice, *The Hidden Entitlements* (Washington, DC: Citizens for Tax Justice, April 1995).

Congressional Research Service, *Tax Expenditures: Compendium of Background Material on Individual Provisions* (Washington, DC: U.S. Government Printing Office, November 1992).

Ernst & Young, *1997 World Corporate Tax Guide* (New York, NY: Ernst & Young, 1997).

Yitzhak Hadari, "The Role of Tax Incentives in Attracting Foreign Investments in Selected Developing Countries," *International Lawyer*, Spring 1990.

Robert G. Lynch, *Do State and Local Tax Incentives Work?* (Washington, DC: Economic Policy Institute, 1996).

Jeffrey Owens, *Emerging Issues in Tax Reform* (Paris, France: Organization for Economic Cooperation and Development, 1997).

"Principles for Global Corporate Responsibility: Bench Marks for Measuring Business Performance," *Corporate Examiner*, September 1, 1995.

Janice Shields, "Ending Corporate Tax Breaks," *Journal of Commerce*, May 15, 1995.

U.S. General Accounting Office, *International Taxation: Transfer Pricing and Information on Nonpayment of Tax* (Washington, DC: GAO, April 1995).

Now Available *Global Focus: A New Foreign Policy Agenda 1997-1998*

Edited by Tom Barry (IRC)
and Martha Honey (IPS)

Fifty sections examine the spectrum of U.S. foreign policy, "succeeding where others fail in honestly dealing with our policy shortcomings." -Rep. John Conners, (D-MI)

\$15.95

(plus #3.00 shipping and handling)

To order *Global Focus*, contact the IRC.

Comments on the *In Focus* briefs are found in *The Progressive Response*, the project's weekly electronic forum. To subscribe, send email to newusfp-manager@zianet.com with the message: "join newusfp."

Back Issues of *Foreign Policy In Focus*

(\$2.50 each, postpaid. Bulk orders: \$12 for 10 copies of the same issue.)

Afghanistan	Colombia	International Trade	Overseas Drug Control
Africa Economic Policy	Congo/Zaire	Investment/Competitiveness	Overseas Rural Development
Africa Overview	Controlling the TNCs	Investment Funds	Panama
Africa Peace and Security	Costs of NATO Expansion	Iran	Peacekeeping and the UN
Albania	Dangers of NATO Expansion	Iraq	Peru
APEC	Defense Conversion	Islamic Movements	Restructuring Transitional States
Arms Trade	Eritrea	Israel	Russia
Arms Sales to Latin America	Export Import Bank	Japan	Somalia
Asia/Pacific Overview	Export Promotion Programs	Mexico	South Africa
Asia/Pacific Security	Foreign Agricultural Policy	Middle East Oil	Strategic Reach in the Middle East
Burma	Foreign Economic Aid	Military Modernization	Sudan
Burundi	Former Yugoslavia	Military Strategy	Trade and Environment
Cambodia	Free Trade Area of Americas	Multilateral Agreement on Investment	Trade and Labor
Central America Peace and Security	Haiti	Multilateral Debt	USIA
Chemical/Biological Weapons	G-7 Summit	NAFTA	U.S. Military Training for Latin America
Child Labor in the Global Economy	Human Rights	Nicaragua	U.S.-U.N. Relations
China	Immigration Debate	Nigeria	Warfare vs Welfare
CIA, Drugs, and Crack	Indochina	North Korea	World Trade Organization
	Indonesia	Nuclear Nonproliferation	
	Intelligence Apparatus	OPIC	
	Int'l Financial Institutions		

To subscribe to *Foreign Policy In Focus*, or to order back issues, contact the IRC at:

PO Box 4506 ♦ Albuquerque, NM ♦ 87196-4506

Phone: (505) 842-8288 ♦ Fax: (505) 246-1601 ♦ Email: resourcectr@igc.apc.org ♦ Website: <http://www.zianet.com/infocus>