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Tax-Motivated Income Shifting For Multinational Firms in U.S.

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Abstract

With the rapid growth of global foreign investment by multinational firms in recent years, the problem of tax-motivated income shifting is becoming more and more serious all over the world. Multinational firms shift income across jurisdictions from high-tax countries to low-tax countries so that they can reduce the effective foreign income tax rate and achieve a higher after-tax profit. There are two tax regimes for international income in the world – territorial tax regime and worldwide tax regime. The territorial tax system generally exempts foreign income from home country tax; while the worldwide system taxes foreign income at its home country rate with the permission of using foreign tax credit by multinational firms. Even though the vast majority of worldwide countries are using the territorial tax system, the controversy about which system is better in terms of global economic development continues.

The United States is under a modified worldwide tax system presently. In order to avoid a large amount of foreign tax loss derived from income shifting, the U.S. government enacted many interrelated foreign tax policies in the past a few decades. President Obama also announced several international tax reform proposals in 2012, aiming to bring more foreign-source income back and reducing the domestic unemployment rate.

In part II, this report examines the pros and cons of territorial and worldwide tax systems. In part III, the most popular approaches of oversea income shifting these years are introduced. Part IV is the evaluation of different U.S. tax policies in relation to foreign income shifting. Part V will introduce President Obama's current tax proposals with regard to reducing oversea income shifting for multinational firms. Part VI is the summary and recommendations, where I will attempt to analyze the optimal foreign tax strategies for the United States to maximize its economic benefits in the long run based on the consideration of the current worldwide economic environment and the cost-benefit analysis.

Key Words: Tax System, Income Shifting, Transfer Pricing, Tax Avoidance

I. Introduction

I.1 Background

In the past a few decades, the worldwide income of U.S. multinational firms has increased sharply. An investigation shows that "over the period from 1990 to 2006, global foreign direct investment by multinational enterprises grew at an annual rate of 12.4%." In U.S., the foreign share of pre-tax worldwide income grew from one third to more than 50 percent from 1996 to 2004 based on data derived from the federal income tax files of 754 large international corporations. In order to reduce the effective foreign income tax rate and achieve a higher after-tax profit, multinational corporations shift income across jurisdictions from high-tax countries to low-tax countries, such as Ireland and Cyprus, and defer repatriation as long as possible. Even though there are a lot of reasons of shifting income for international corporations, such as risk sharing, market expanding, and oversea stock earning, in reality, tax avoidance is one of the most important reasons.

As we know, there are two tax regimes for international income in the world – territorial tax regime and worldwide tax regime. At present, most developed countries, such as Japan and UK, are using the territorial tax system, which generally exempts foreign income from home country tax. Differently, the U.S. adopts a worldwide system of taxation, which taxes foreign income at its home country rate, but allowed certain foreign tax credit for this income.

I.2 Statement of Purpose

The purpose of this report is to evaluate different historical U.S. tax policies and current tax proposals with regard to reducing oversea income shifting for multinational firms. In order to achieve this purpose, I will introduce the pros and cons of territorial and worldwide tax systems first, followed by investigating the most popular ways of current oversea income shifting. This report will attempt to analyze the optimal foreign tax strategies for the United States to maximize its economic benefits in the long run based on the consideration of the current worldwide economic environment and the cost-benefit analysis.

II. Territorial vs. Worldwide Tax Systems

II.1 Territorial Tax System

Territorial countries generally exempt the foreign earnings of their multinationals in their domestic tax returns. Specifically, under the territorial tax system, multinational firms only need to pay their income tax in the host countries where their foreign subsidiaries are located and earning profits. Kevin Markel's study in 2012 indicates that territorial firms engage in more tax-motivated income shifting than worldwide firms . This makes sense because since the earnings and losses incurred by the foreign subsidiaries are isolated, the corporations can advance their worldwide after-tax profits by purposely shifting more income to the jurisdictions with lower corporate income tax rates. The biggest advantage of the territorial tax system is that it can eliminate the double taxation of oversea income thoroughly. However, the loss of foreign income taxes limits the territorial countries from raising funds internationally, which could reduce the government revenue largely under the new position of global economic integration.

II.2 Worldwide Tax System

Under the worldwide tax system, the multinational corporations have to pay their corporate income tax on all income to the home country where their headquarters are located regardless of whether the income is earned in the home country or host country. It means that these enterprises have to pay the foreign income tax twice in both the host and home countries. Usually, a worldwide country allows foreign tax credit or foreign income deduction to reduce the double taxation, although the usefulness of credits or deductions is very limited in handling this problem. Another shortage of the worldwide tax system is its competitive disadvantage in the global marketplace. Since this system constrains the effectiveness of tax avoidance through income shifting, it accelerates the relocation of corporate headquarters and reduces domestic job opportunities subsequently.

The U.S. has a modified rather than a pure worldwide tax system, in which it allows certain tax deferral through foreign subsidiaries before the repatriation of earnings. A U.S. based foreign company pays no U.S. tax on the foreign source income unless and until the company pays a dividend (real or constructive) or payment in compensation of services (e.g., interest, royalty) to its U.S. parent. As a result, these companies will try to defer repatriation as long as possible through temporary or permanent reinvestment of their foreign earnings.

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III. Popular Strategies of Income Shifting for Multinational Firms

In Harry Grubert's study of U.S. multinational company income aboard, it appears that there was an approximate five percentage decline in the average effective foreign tax rates between 1996 and 2004 for these companies . Using the income shifting to those tax haven jurisdictions, multinational firms benefit from lower foreign tax burdens, and therefore get a higher worldwide profit margin. A few popular ways of income shifting for multinational firms are listed as follows.

III.1 Transfer Pricing

Transfer price distortion is the most popular approach of boosting earning incomes in foreign subsidiaries located in tax shelters. The lower the intra-firm transfer price charged by high-tax affiliates for raw materials, trading goods, intangible assets, or services rendered, the greater the income shifted to low-tax affiliates.

III.2 Intra-firm Debt and Equity

While transfer pricing can affect a subsidiary's operating income, distortion to intra-firm debt and equity occurs to affect the company's financial income. Through purchasing stocks or bonds issued by parent company located in a high-tax jurisdiction, subsidiaries in low-tax jurisdictions can earn dividends or interests from their parent company, hence achieve the purpose of profit shifting. Unfortunately, this advice is impossible in U.S. since the U.S. tax law "treats a controlled foreign corporation's debt or equity investment in its U.S. parent as a repatriation of earnings" , which is taxable in U.S.

III.3 Foreign Earnings Reinvested

Since certain tax deferral through foreign subsidiaries is allowed before the repatriation of earnings, U.S. parent companies prefer to reinvest their foreign earnings in the subsidiaries with lower corporate income taxes and result in a tax savings from the tax deferral based on the time value of money concepts. However, if the subsidiary has a higher foreign tax rate relative to the U.S. rate, the U.S. parent would rather repatriate the foreign earnings immediately and use the foreign tax credit to offset the U.S. tax on foreign income completely. Multinational firms can even avoid recording a deferred U.S. tax liability through reinvesting their foreign earnings permanently abroad.

III.4 "Disappearance" of Foreign Subsidiaries

The "check-the-box" rule was implemented in 1997, under which the money transferred from a foreign subsidiary to its U.S. parent is not treated as passive income and therefore will not trigger a current U.S. tax liability. This is because under the rule, the U.S. parent could elect to treat its foreign subsidiary in a tax haven as a disregarded entity. As a result, the subsidiary would "effectively disappear for U.S. tax purposes" . However, the host government still regards the subsidiary as a corporation and allows a tax deduction for the payment. By using such "hybrid" entities, U.S. firms are able to shift income to tax haven jurisdictions and reduce their foreign effective tax rates largely.

Here are two examples of "disappearance" of foreign subsidiaries in reality: Google Inc. listed 108 subsidiaries for 2009 but only two for 2011 in its Exhibit 21 to Form 10-K; Microsoft Corporation reduced its reported subsidiaries from 28 in 2006 to eight in 2011.

IV. U.S. Historical Policies to Reduce Oversea Income Shifting

IV.1 IRC §482

Starting with the IRC §482 introduced in 1962, any transfer price distortion will be under the supervision of IRS and result in income reallocation for tax purpose based on the arm's length standard. Since then, any inappropriate transfer price in relation to income shifting has been restricted effectively.

IV.2 "Antideferral" Rules

Through postponing the repatriation of foreign earnings, U.S. based multinational firms can defer their foreign income tax liability until the repatriation of foreign earnings. "Antideferral" rules implemented in 1962 indicates that any U.S. shareholders with "more than 50 percent of voting power or stock value" in foreign corporations must recognize any subpart F income earned by those firms immediately no matter if the income is repatriated to or not . This is also known as "equity method", in which the shareholders' tax basis is increased on income earned and is reduced on cash or property dividends received from the controlled foreign corporations. Even though the constructive repatriation of foreign source income is only limited to subpart F income, the "antideferral" rules accelerate the recognition of foreign income under the U.S. tax purpose.

IV.3 FAS No. 109 and ASC 740-30-50

In order to promote the book-tax conformity, FAS 109 (1992) states that any deferred tax liability and deferred tax asset must be recognized for temporary differences which will result in taxable and deductible amounts in future years, respectively; ASC 740-30-50 (2009) requires "the disclosure of permanently reinvested foreign earnings for which a deferred tax liability is not recorded" . Through the recognition of deferred foreign tax liabilities and the disclosure of permanently reinvested earnings in foreign subsidiaries, these rules facilitate the public scrutiny of management behaviors, consequently constraining the tax-avoiding reinvestment in low-tax jurisdictions.

V. President Obama's International Tax Reform Proposals

Seeking to bring more foreign-source income back into the U.S. tax base and undertake more domestic investment, President Obama announced several international tax reform proposals in May, 2012, involving three specific foreign tax aspects as follows.

V.1 Current Deferral of Foreign Income

In this proposal, deferral of foreign income is still allowed, while the related expense deductions will be postponed in accordance with the matching principle. Due to the restriction of accelerated expense deductions, the U.S. may be able to collect higher tax revenues from the foreign income. This proposal "brings the U.S. tax system closer to a pure worldwide system."

V.2 Foreign Tax Credit

Currently, U.S. tax laws allow a foreign tax credit based on the constructive repatriation of foreign earnings up to the foreign source income times the U.S. tax rate. The excess foreign tax paid can be carried back one year and forward 10 years. Contrastively, the proposal would require "the foreign

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tax credit to be based on the amount of total foreign tax the taxpayer actually pays on its total foreign earnings" and exclude the ability of carry-backs or carry-forwards for any excess foreign tax credit.

V.3 "Check-the-box" Rules

Previous study indicated that the application of "check-the-box" rules contributes 20 to 40 percentage of total decline in average foreign effective rates because of the irrecognition of passive income between two subsidiaries. The proposal excludes the possibility of "disappearing" offshore subsidiaries and treats this type of income as subpart F income which subjects to U.S. tax immediately. It thoroughly eliminates the chance of tax avoidance by using the "check-the-box" rules, hence reduces the income shifting activities to overseas tax havens.

VI. Conclusions

VI.1 Summary

Profit shifting of multinational corporations to tax haven jurisdictions is considered to be a major threat to the tax base of high-tax economies around the world. It distorts company's foreign earnings of low-tax subsidiaries and reduces the foreign income tax revenues of high-tax jurisdictions. Income shifting activities exist in both territorial tax regime and worldwide tax regime. Different tax strategies are used to shift income to low-tax subsidiaries – transfer pricing, intra-firm debt and equity, foreign earnings reinvestment, disrelation of foreign subsidiaries, and so on. Along with the sharp increase of the share of worldwide income earned abroad, tax laws and standards are published in the U.S. in order to eliminate or reduce income shifting. Aiming for more foreign income tax revenue and a better domestic employment environment, president Obama also announced several tax reform proposals in relation to income shifting in 2012. Since both territorial and worldwide tax systems have their own advantages, no matter which strategy is chosen against tax-motivated income shifting, it comes with pros and cons.

VI.2 Recommendations

Compared to prior studies in this area, my suggestion could be a little more conservative and long-run focused. Based on the consideration of current worldwide economic environment and the cost-benefit analysis, I would recommend the adoption of territorial tax system for U.S. based international income and ask for certain adjustment of corporation income tax rate.

The adoption of territorial tax system is the latest trend for foreign earnings throughout the world. Since the system treats the earnings abroad in isolation, it thoroughly eliminates the double-taxation problem, excludes the complicated supervision of foreign income, calls of the use of foreign tax credit, and therefore simplifies the tax policy and cuts down the human resource costs used to handle the international tax enforcement. Besides, since multinational companies do not need to defer the foreign tax liability anymore, this will drag back a portion of permanent reinvestment overseas and accelerate the repatriation of foreign income to its parent company, as well as stimulating the income distribution to the shareholders in U.S. and collecting income tax for dividends.

Even though the territorial tax system tends to engage in more tax-motivated income shifting than the worldwide system based on previous studies, the reduced incentive of relocating corporate headquarters to territorial countries and the steadier growth of domestic job opportunities may offset this shortage to some extent.

There is no doubt that the United States has the most advanced technology, many cutting-edged professionals, and the widest consumer market all over the world. However, in the recent years, there are still more and more American multinationals shifting their business and profits outside the U.S. in pursuit of lower taxes, cheaper labor, and preferential policies overseas. So how can the U.S. market win back its competitive advantages according to the comprehensive consideration? As the root cause of income shifting, tax rate is a significant reason that affects decisions by multinational firms on where to locate investment and income. Reasonably cutting down the corporate income tax is a useful way to improve the competitive power of U.S. and activate the American market economy again. Compared to president Obama's tightening tax proposal, I think a loose policy with a lower corporate tax rate may do a better job to win back the lost market sharing, repatriate more foreign source income, and reduce the unemployment rate steadily.

I believe that the suggestion above could help the U.S. to stimulate its economical development in the long run. However, the negative effects arrived from the suddenly reduced tax revenue could be pretty conspicuous at the beginning. No matter what, the approval of the optimal foreign tax strategies to maximize U.S. economic benefits is still waiting to verify in the future.

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