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by

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Taxation of Foreign Income

ABSTRACT

Taxation of foreign income entails the taxation by one country of income that its residents earn in another country. While most countries exempt active foreign business income from taxation, several large capital exporters subject foreign income to taxation but permit taxpayers to claim credits for taxes paid to foreign governments. There is extensive empirical evidence that the taxation of foreign income influences the magnitude of foreign investment, and the tax avoidance activities of investors. Neutral taxation of foreign income entails considerations not only of the volume and location of investment, but also the effects of taxation on capital ownership.

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1. Introduction

Taxation of foreign income entails the taxation by one country of income that its residents earn in another country.

Most countries subject some types of foreign income to taxation. Since this income is also typically taxed by foreign countries in which it is earned, there is considerable scope for ruinous double taxation. For example, in the 1970s the corporate tax rate in the United States was 48 percent while the corporate tax rate in Germany was 56 percent; without some attenuation of double taxation, the combined tax rate of 104 percent likely would have discouraged (profitable) American corporate investment in Germany.

International practice since the dawn of taxation is that countries tax income earned within their borders, whereas countries in which taxpayers are resident grant tax relief for foreign income in order to reduce or eliminate double taxation. There are two primary alternative methods by which residence countries grant relief, the first being to exempt foreign income from taxation, and the second being to permit residents to claim credits for taxes paid to foreign governments. Many countries combine these systems, exempting active foreign business income from taxation while subjecting foreign personal income to taxation but permitting individuals to claim credits for income taxes paid to foreign jurisdictions.

The nature of international commerce is such that most foreign income is earned by businesses rather than individuals. Many countries largely exempt active foreign business income from taxation, though a number of major capital exporting nations, including the United States, the United Kingdom, and Japan, tax foreign income while granting credits for taxes paid to foreign governments. With such a system of taxing foreign income, and a home country corporate tax rate of 35 percent, a corporation that earns 100 in a foreign country that imposes 10

percent tax rate pays taxes of 10 to the foreign government and 25 to its home government, since its home country corporate tax liability of 35 is reduced to 25 by the foreign tax credit of 10. Since foreign tax credits are intended to alleviate international double taxation, credits are limited to home country taxes due on foreign income; taxpayers are not permitted to use taxes paid to foreign governments to reduce home country tax liability on domestic income. In addition, countries that tax active foreign income permit taxpayers to defer home country taxation of certain business profits earned and reinvested abroad; that income is taxed only when repatriated to the country of residence.

2. Effects of taxing foreign income

The taxation of foreign income and the tax laws of other countries have the potential to influence a wide range of corporate and individual behavior, including, most directly, the location and scope of international business activity. Studies of behavioral responses to international tax rules find that multinational firms invest less in high-tax countries than they do in otherwise-similar low-tax countries. This is most evident from the disproportionate shares of financial and real investment in tax haven countries (Hines, 2005), but also appears in cross-sectional econometric estimates of the determinants of foreign investment. Controlling for income levels and other observable characteristics of host countries, foreign direct investment levels are negatively associated with local corporate tax rates, the implied elasticity of investment with respect to the tax rate generally lying close to –0.6 in data covering the 1980s (Hines and Rice, 1994), and increasing in magnitude to -1 or greater in evidence data since the 1990s (Altshuler, Grubert and Newlon, 2001). High rates of local taxes other than corporate

income taxes are likewise associated with reduced levels of foreign investment (Desai, Foley and Hines, 2004a).

There is extensive evidence that firms arrange financial flows and intrafirm sales to reallocate taxable income from high-tax countries to low-tax countries. This reallocation is commonly accomplished by concentrating corporate borrowing, and therefore interest deductions, in high-tax countries (Desai, Foley and Hines, 2004b), and by adjusting prices paid for intrafirm financial transactions and sales of goods and services to minimize income reported in high-tax countries (Clausing, 2003). As a consequence, multinational firms report significantly higher profit rates in low-tax countries than in high-tax countries (Desai, Foley and Hines, 2003), and the ability to reallocate taxable income only increases the attractiveness of investing in low-tax countries.

Taxation of foreign income, together with provision of foreign tax credits, dampens incentives to earn income in low-tax countries, since lower foreign tax payments reduce available foreign tax credits and thereby create greater home country tax obligations. Foreign investment in the United States is consistent with these incentives, in that investors from countries that exempt foreign income from taxation concentrate their investments more heavily in low-tax states than do investors from countries that tax foreign income (Hines, 1996). The taxation of foreign income restricts the attractiveness of investment in low-tax countries to situations either in which ample foreign tax credits are available, or in which investors can profitably defer home-country taxation. In practice, American firms are much more likely to reinvest foreign profits earned in low-tax locations, since immediately returning these profits to the United States would produce significant tax obligations (Desai, Foley and Hines, 2001).

The impact of home country taxation is illustrated by the practice of granting "tax sparing" credits for investments in certain developing countries, thereby permitting taxpayers to claim credits for normal rates of foreign taxes, whether or not actually paid. Evidence indicates that Japanese investors are much more likely to receive local tax concessions in countries with which Japan has "tax sparing" agreements than they are elsewhere, and that Japanese investment is concentrated in these countries as a result (Hines, 2001). Finally, the taxation of foreign income has even encouraged some individuals and multinational firms to expatriate, effectively changing their places of tax residence to avoid home-country taxation of lightly-taxed foreign income (Desai and Hines, 2002).

3. Neutral taxation of foreign income

International tax rate differences may encourage inefficient allocation of economic activity; consequently, considerable effort has been devoted to understanding the properties of tax systems creating neutral incentives.

Capital export neutrality (CEN) is the doctrine that an investor's income should be taxed at the same total rate regardless of the location in which it is earned. If a home country tax system satisfies CEN, then a firm seeking to maximize after-tax returns has an incentive to locate investments in a way that maximizes pre-tax returns. This allocation of investment promotes global economic efficiency under certain circumstances. The CEN concept is frequently invoked as a normative justification for taxation of foreign income with provision of foreign tax credits (Richman, 1963), though in practice, countries limit foreign tax credits and commonly defer taxation of unrepatriated active business income.

The same logic implies that governments acting on their own, without regard to world welfare, should want to tax the foreign incomes of their resident companies while permitting only deductions for foreign taxes paid. Such taxation satisfies what is known as national neutrality, discouraging foreign investment by imposing a form of double taxation, but doing so in the interest of the home country that disregards the value of tax revenue collected by foreign governments. From the standpoint of the home country, foreign taxes are simply costs of doing business abroad, and therefore warrant the same treatment as other costs. This line of thinking suggests that countries fail to advance their own interests in permitting taxpayers to claim foreign credits, or worse, in exempting foreign income from taxation.

A third neutrality principle is capital import neutrality (CIN), the doctrine that the return to capital should be taxed at the same total rate regardless of the residence of the investor. Pure source-based taxation at rates that differ between locations can be consistent with CIN, since different investors are taxed at identical rates on the same income. In order for such a system to satisfy CIN, however, it is also necessary that individual income tax rates be harmonized, since CIN requires that the combined tax burden on saving and investment in each location not differ between investors. While CEN is commonly thought to characterize tax systems that promote efficient production, CIN is thought to characterize tax systems that promote efficient saving (Horst, 1980).

The importance of ownership for productivity, and the reality that much foreign investment consists of acquisitions of existing assets by new owners, has prompted analysis of the features of tax systems that do not distort ownership of capital. Capital ownership neutrality (CON) is satisfied if every country taxes foreign income similarly, thereby avoiding tax-based ownership clienteles (Desai and Hines, 2003). From the standpoint of capital ownership, a

country fails to advance world welfare by adopting a tax system that promotes CEN, if most capital exporters exempt foreign income from taxation.

The same circumstances that make CON desirable from the standpoint of world welfare also imply that countries acting on their own have incentives to exempt foreign income from taxation, regardless of what other countries do. The reason is that additional outbound foreign investment does not reduce domestic activity, since reduced home-country investment by domestic firms is offset by greater investment by foreign firms. Home-country welfare rises with the productivity of domestic factors, and is maximized by ownership patterns produced by exempting foreign income from taxation. Tax systems that exempt foreign income from taxation are therefore said to satisfy national ownership neutrality. Hence it is possible to understand why so many countries exempt active foreign business income from taxation, and it follows that, if every country did so, capital ownership would be allocated efficiently, to the benefit of global productivity.

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