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Appendix

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Most of the papers in this volume examine the impact of U.S. tax rules on the behavior of multinational corporations. Since reference to certain rather detailed aspects of the U.S. tax system occurs repeatedly in these papers, this appendix describes two of the major features of U.S. taxation of its resident multinational companies: how firms can defer U.S. taxation of certain foreign earnings, and how to determine whether an American company has "excess foreign tax credits."

The United States taxes income on a residence basis, meaning that American corporations and individuals owe taxes to the U.S. government on all their worldwide income, whether earned inside or outside the United States. In order to avoid subjecting American multinationals to double taxation, U.S. law permits firms to claim foreign tax credits for income taxes (and related taxes) paid to foreign governments.[1] The U.S. corporate tax rate is currently 35 percent. Under the foreign tax credit system, a U.S. corporation that earns $100 in a foreign country with a 15 percent tax rate pays a tax of $15 to the foreign government and $20 to the U.S. government, since its U.S. corporate tax liability of $35 (35 percent of $100) is reduced to $20 by the foreign tax credit of $15.

Deferral of U.S. Taxation

Under U.S. law, Americans must pay tax to the U.S. government on their worldwide incomes, except for a certain category of foreign income that is

1. The U.S. government is not alone in taxing the worldwide income of its resident companies while permitting firms to claim foreign tax credits. Other countries with such systems include Canada, Italy, Japan, Norway, and the United Kingdom. Under U.S. law, firms may claim foreign tax credits for taxes paid by foreign affiliates of which they own at least 10 percent, and only those taxes that qualify as income taxes are creditable.

temporarily excluded from U.S. taxation. The excluded category is the unrepatriated portion of the profits earned by foreign subsidiaries; taxpayers are permitted to defer any U.S. tax liabilities on those profits until those profits are paid as dividends to the United States.[2] This deferral is available only on the active business profits of American-owned foreign affiliates that are separately incorporated as subsidiaries in foreign countries. The profits of unincorporated foreign businesses, such as those of U.S.-owned branch banks in other countries, are taxed immediately by the United States.

To illustrate deferral, consider the case of a U.S.-owned subsidiary that earns \$500 in a foreign country with a 10 percent tax rate. This subsidiary pays taxes of \$50 to the foreign country (10 percent of \$500), and might remit \$100 in dividends to its parent U.S. company, using the remaining \$350 (\$500 − \$50 of taxes − \$100 of dividends) to reinvest in its own foreign operations. The U.S. parent firm must then pay U.S. taxes based on the \$100 of dividends it receives (and is eligible to claim a foreign tax credit for the foreign income taxes its subsidiary paid on the \$100). But the U.S. firm is not required to pay U.S. taxes on any part of the \$350 that the subsidiary earns abroad and does not remit to its parent U.S. company. If, however, the subsidiary were to pay a dividend of \$350 the following year, the firm would then be required to pay U.S. tax on that amount (after proper allowance for foreign tax credits).

U.S. tax law contains provisions designed to prevent American firms from delaying the repatriation of lightly taxed foreign earnings. These tax provisions apply to controlled foreign corporations, which are foreign corporations owned at least 50 percent by U.S. corporations or individuals holding stakes of at least 10 percent each. Under the subpart F provisions of U.S. law, certain types of the foreign income of controlled foreign corporations are "deemed distributed" and are therefore immediately taxable by the United States, even if not repatriated as dividend payments to American parent firms. This subpart F income can be from passive investments (such as interest and dividends received from investments in securities), foreign base company income (which arises from using a foreign affiliate as a conduit for certain types of international transactions), income that is invested in U.S. property, money used offshore to insure risks in the United States, and money used to pay bribes to foreign government officials. American firms with foreign subsidiaries that earn profits through most types of active business operations and that subsequently reinvest those profits in active lines of business are not subject to the subpart F rules, and are therefore able to defer U.S. tax liability on their foreign profits until they choose to remit dividends at a later date.

2. Deferral of home-country taxation of the unrepatriated profits of foreign subsidiaries is a common feature of systems that tax foreign incomes. Other countries that permit this kind of deferral include Canada, Denmark, France, Germany, Japan, Norway, Pakistan, and the United Kingdom.

Excess Foreign Tax Credits

The U.S. government permits American firms to claim foreign tax credits, with the understanding that this policy reduces the tax revenue collected by the United States on any given amount of foreign-source income. The foreign tax credit is intended to reduce the problems created by international double taxation. Consequently, the U.S. government is careful to design the foreign tax credit in a way that prevents American firms from using foreign tax credits to reduce U.S. tax liabilities that arise from profits earned *within* the United States.

The government imposes limits on the foreign tax credits that U.S. firms can claim; a firm's foreign tax credit limit equals the U.S. tax liability generated by the firm's foreign-source income. For example, with a U.S. tax rate of 35 percent, an American firm with $200 of foreign income faces a foreign tax credit limit of $70 (35 percent of $200). If the firm pays foreign income taxes of less than $70, then the firm would be entitled to claim foreign tax credits for all of its foreign taxes paid. If, however, the firm pays $95 of foreign taxes, it would be permitted to claim no more than $70 of foreign tax credits.

Firms described by this second case, in which foreign tax payments exceed the foreign tax credit limit, are said to have excess foreign tax credits; the excess foreign tax credits represent the portion of their foreign tax payments that exceeds the U.S. tax liabilities generated by their foreign incomes. Firms described by the first case, in which foreign tax payments are less than the foreign tax credit limit, are said to have excess foreign tax limitation.[3] Under U.S. law, firms can, under some circumstances, use excess foreign tax credits in one year to reduce their tax obligations for other years. Firms are allowed to apply any excess foreign tax credits against their U.S. tax obligations for up to the two previous years, and to recalculate their tax returns for those years while choosing when to apply the excess foreign tax credits. If a firm prefers, it can instead apply its excess foreign tax credits against U.S. tax liabilities on foreign income in up to the following five years.[4]

In practice, the calculation of the foreign tax credit limit entails many complications not addressed here. One major feature of the calculation should, however, be noted: U.S. law requires firms to use all of their worldwide foreign

3. An equivalent phrase used to describe firms with excess foreign tax limitation is to say that they have deficit foreign tax credits. These two phrases are used interchangeably.

4. Foreign tax credits are not adjusted for inflation, so firms generally find them to be the most valuable if claimed as soon as possible. Barring unusual circumstances, firms apply their foreign tax credits against future years only when they are unable to apply them against either of the previous two years. The most common reason for inability to apply excess foreign tax credits is that a firm already has excess foreign credits in those two years.

income to calculate the foreign tax credit limit. Firms then have excess foreign tax credits if the sum of their worldwide foreign income tax payments exceed this limit.[5] This procedure is known as worldwide averaging.

5. Not all countries that grant foreign tax credits use worldwide averaging. For example, while Japan uses worldwide averaging, the United Kingdom requires its firms to calculate foreign tax credits on an activity-by-activity basis. The United States used to require firms to calculate separate foreign tax credit limits for each country to which taxes were paid; the current system of worldwide averaging was introduced in the mid-1970s.