



International tax policy

Tashkent State University of Economics

Lecture 8



Take Away Points

- ◎ The taxation of foreign income directly affects the U.S. tax base
- ◎ If foreign income is taxed at a lower combined effective rate than U.S. income, taxpayers will shift U.S. income to foreign income
- ◎ Reduced taxation of foreign income subsidizes U.S. investment in low-tax foreign countries - Why there and not in Des Moines?



Take Away Points

◎ Allowing high foreign taxes to be used as credits

- to offset U.S. tax on low-taxed foreign income, or
- to offset U.S. tax on U.S. income treated as foreign under current rules

subsidizes countries that impose high foreign taxes

Take Away Points

◎ Today, US tax planners:

- reduce foreign taxes below U.S. effective rate,
- defer U.S. tax on foreign income subject to low effective foreign income tax, and
- use transfer pricing to shift additional income to low-tax deferral environment, and
- when income is repatriated to the U.S., cross-credit excess foreign tax credits from high-taxed foreign income to offset U.S. tax on low-taxed foreign income in same foreign tax credit limitation category

Take Away Points

- ◎ This tax planning has been rewarded by favorable court decisions and Congressional passage of homeland dividend relief
 - Untaxed earnings may be repatriated for one year at effective U.S. tax rate of 5.25% or less if reduced by foreign tax credits

Take Away Points

- ◎ There is no reason to tax a U.S. person's foreign income more favorably than U.S. income
- ◎ A credit should be allowed for foreign tax to avoid double taxation of income
- ◎ The unproven efficiency gains of lower taxation of foreign income do not outweigh:
 - the strong equity arguments against favored treatment of foreign income
 - the very substantial complexity required to achieve and defend favored treatment of foreign income
 - The inevitable and wasteful tax planning that will result

Take Away Points

- ◎ Fundamental reforms, described below, that reduce the effective rate differential between U.S. and foreign income are feasible if tax reform broadens business tax base and lowers U.S. tax rate on business income

International Tax Reform Alternatives

◎ Fundamental international tax reform alternatives include:

- Expand current taxation of U.S.-controlled foreign corporation earnings, subject to a foreign tax credit that constrains cross-crediting, or
- Exempt active foreign business income that bears a sufficient effective rate of foreign tax (or have a functionally equivalent condition) to mitigate tax-motivated shifting of economic activity

International Tax Reform Alternatives

- ◎ Expand Current Taxation of Foreign Income
 - Expansion of current taxation of U.S.-controlled foreign corporation earnings, unlike exemption, would not encourage investment in lower-taxed countries
 - Expansion of current taxation of U.S.-controlled foreign corporation earnings would encourage non-tax motivated redeployment of earnings (there would be no separate “repatriation tax”)
 - Expansion of current taxation of foreign income would reduce many complexities arising from deferral

International Tax Reform Alternatives

- Expanded current taxation of foreign income should be accompanied by improvements to the foreign tax credit to restrict cross-crediting against low-taxed foreign income and U.S. income masquerading as foreign income
- It also will be necessary to balance improved residence taxation of U.S. persons with stronger U.S. source taxation of foreign-owned business to discourage expatriation to foreign ownership

International Tax Reform Alternatives

- ◎ A second best alternative: Exemption of active foreign business income
 - An exemption proposal should require a minimum foreign effective rate of tax or a functional equivalent as a condition for exemption of active foreign business income
 - Like current taxation, exemption would eliminate the repatriation tax, but
 - Exemption also would encourage U.S. persons who can perform some business activities abroad but who need the cash in their U.S. business to shift business functions abroad

International Tax Reform Alternatives

◎ Exemption of active foreign business income (cont'd)

- It is critical not to exempt active foreign business income that is not foreign and not subject to foreign tax or the problems of current law will remain and worsen

International Tax Reform Alternatives

- ◎ If the U.S. shifts to a consumption tax and does not continue to tax business income,
 - foreign countries will have little reason to keep income tax treaties with the U.S.
 - foreign countries could increase their income taxation of U.S. companies' foreign business operations