



US Taxation of Foreign Income

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The current US system of taxing foreign income has unwittingly created a hostile climate for US-based multinational enterprises (MNEs) while encouraging high-technology production abroad and facilitating tax evasion on portfolio income. Over the last two decades, US-based MNEs—especially in high-technology industries—have dramatically expanded their business operations abroad and now generate a large portion of their income from activities outside the United States. In fact, household-name corporations—such as General Electric and IBM—often earn more than half their profits from overseas sources.

The US tax system provides unintended incentives for MNEs

- *to locate high-technology production abroad.* This shift is encouraged because implicit royalty and fee income earned from production in the United States often pays a higher total tax than explicit royalties and fees earned from production of the same goods and services outside the United States.
- *to shift their headquarters activities abroad.* The US worldwide tax system extends its reach to foreign production and sales income, unlike the systems of most competitor countries. Moreover, the US system contains unfavorable rules for allocating research, development, and administrative expenses. These features prompt global enterprises to think about placing their headquarters in cities like London, Singapore, or Dubai rather than New York, Chicago, or Los Angeles.

In addition to these two major competitive defects, the US tax system facilitates tax evasion on foreign portfolio income paid or accrued to US residents. Tax abuse is the natural corollary of underreporting, and the absence of effective international cooperation enables US companies and individuals to conceal their passive portfolio income earned from foreign sources.

Hufbauer and Assa recommend tax policy reforms that would encourage MNEs to locate both headquarters activities and high-technology production in the United States. To achieve these goals, they

- propose that the US tax regime should be shifted toward a territorial system, coupled with favorable expense allocation rules. (Under a full territorial system, the United States would tax all income earned at home, but it would not tax active business income earned abroad.)
- suggest a new approach for taxing royalty and fee income earned abroad so that high-technology production in the United States is not penalized by comparison with production abroad.

The authors also urge the United States to take the lead in creating a cooperative international system that would discourage underreporting of foreign portfolio income, including by US residents. These proposed reforms, the authors calculate, might collect more tax revenue than the present system, paving the way for a lower corporate tax rate or other forms of business tax relief.

This study updates and extends an earlier Institute volume by Hufbauer on international taxation published in 1992, *US Taxation of International Income: Blueprint for Reform*. Some of the recommendations made at that time have found their way piecemeal into the US tax system. For example, the American Jobs Creation Act of 2004 marginally moved the US system toward a territorial model. In the economic glow of the 1990s, however, the United States generally grew complacent about its competitive position in the world economy and far-reaching tax reforms were postponed.

The case for reforming US taxation of foreign income is particularly acute in high-technology activities and industries. Those who are content with the US position in the world economy, those who believe that the dominant purpose of tax policy is to raise revenue in a manner that creates the least political stir—or in a manner that is neutral across all forms of economic activity—and those who see only a weak link between tax policy and corporate performance will find little reason to commend this book.

Hufbauer and Assa's recommendations are based on the central proposition, however, that the US position in the world economy should be stronger and that, at the margin, tax policy can make a difference. They readily acknowledge that other forces also matter, such as education, workforce skills, innovation, and cultural attitudes. Many of these forces are more important than tax policy, and in combination they have delivered sterling US economic performance since 1990. However, US tax policy was not among the favorable forces, and the defects of international taxation are the focus of this study.

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