INTRODUCTION

In the December 2004 issue of the National Tax Journal, Desai and Hines claim that the current “U.S. tax burden on foreign income is in the neighborhood of $50 billion a year.” This is, of course, in addition to the foreign host country tax burden, which can be credited against the initial tentative U.S. tax on the income. This alleged $50 billion loss in profits to U.S. corporations resulting from the U.S. tax system is made up of three related components. The first is the estimated $20 billion of U.S. tax collected in 1999 on all corporate income now defined as foreign source under the U.S. tax rules. Based on this initial $20 billion, they conclude that a further $10 billion should be attributed to the effect of the taxes owed on unrepatriated earnings. The final $20 billion is the additional after-tax profits U.S. companies would have been able to earn if all foreign income were totally exempt. U.S. firms would expand investment abroad and have a greater incentive to avoid foreign taxes. Desai and Hines suggest that these large ‘efficiency’ gains justify complete exemption of all foreign income. They also justify the exemption of all foreign income on the basis of their concept of ‘ownership neutrality’ among competing buyers of foreign assets that they introduce at the end of the paper.

Unfortunately, the measure Desai and Hines present seems to have no conceptual basis and cannot be used to address any relevant policy issue. This note shows that each step in their analysis is based on flawed theory and the misinterpretation of data. To begin with, the actual U.S. residual tax on all foreign source income was not $20 billion in 1999; it was substantially less, as we will see, because Desai and Hines use the published data for total foreign source income before ‘adjustments’ for domestic losses. More important, Desai and Hines seem to assume that all of the residual U.S. tax is obtained from dividend repatriations. In fact, a closer look at the data indicates that only a small part (perhaps 15 percent) of the direct tax revenue from ‘foreign’ income is attributable to dividends from active business income. Most of the remainder is derived from payments that are deduct-
ible abroad, such as royalties and interest, or activities performed exclusively in the United States, such as export sales and loans extended by U.S. banks to foreign borrowers. This suggests that the $10 billion attributed to the cost of deferring dividend repatriations is a vast overestimate and is closer to the $1–2 billion estimated in earlier papers, including one by the authors. The discussion of the costs of deferral also fails to consider the various strategies companies can engage in to mitigate them. Indeed, throughout the paper, Desai and Hines assume that companies are passive, naïve victims of government policy without any ability to engage in tax avoidance strategies. In addition to their not accurately identifying the companies’ income that actually results from operations abroad, the Desai–Hines assertions about the expenses that should be linked to this income have no justification. They implicitly assume that parent overhead expenses like interest or R&D never make any contributions to profits abroad.

Before going into more detail, it will be helpful to review the basics of the U.S. system for taxing ‘foreign’ business income. The United States imposes the corporate tax on all repatriated foreign income, which includes not only dividends, but also interest, royalties and other foreign payments such as compensation for services provided abroad. It also includes income defined as foreign source under the U.S. rules, even though, as explained below, it has no connection with any U.S. business activity abroad. The repatriation of equity income from an active business can be deferred, but, under subpart F in the Internal Revenue Code, the deferral privilege is not extended to certain ‘tainted’ income, including passive portfolio income received by foreign subsidiaries and the income from purely trading operations in tax havens.

Taxpayers receive a credit against this tentative U.S. tax for foreign taxes paid on the income, including a credit for the underlying foreign corporate tax linked to a direct dividend, but this credit is limited to what the U.S. tax would have been on the income. Furthermore two steps are important in this foreign tax credit limitation calculation. In the first, the foreign income is separated into ‘baskets’ to reduce cross-crediting, i.e., credits flowing over from a type of income that may be highly taxed to a type that has been lightly taxed. The three important baskets are general nonfinancial active income, financial services income, and passive portfolio income received by controlled foreign corporations. Within any basket, excess credits generated by one type of income (e.g., dividends) can flow over to other income (e.g., royalties) in the basket. In the second step, parent overhead expenses (e.g., interest) are allocated to each basket in order to calculate the net foreign source income on which the credit in the basket can be taken. This affects companies only if they cannot use all of the credits for the foreign taxes they have paid. With this
introduction, we can proceed to review each step in the Desai–Hines analysis.

WHAT TYPE OF FOREIGN INCOME IS THE CURRENT REVENUE DERIVED FROM?

Using data in Raub (2003), Desai and Hines estimate that the U.S. tax actually collected on foreign income in 1999 was $20 billion. This is based on income of $166 billion, taxed at the corporate rate of 35 percent, and credits of $38 billion. But as is clearly stated in Raub (2003), the $166 billion is “before adjustments” for domestic losses.\(^1\) Any measure of the tax burden on a given type of income should reflect the possibility that it can absorb losses from another type. We can evaluate the significance of the adjustments using tabulations of the U.S. Treasury data files for 2000. Income was $196.7 billion before and $174.6 billion after adjustments. The latter is the foreign income that is actually taxed. Accordingly, about one third of the Desai–Hines $20 billion results from this use of the unadjusted data rather than the adjusted data. The total residual tax on foreign income in 2000 was $12.7 billion, reflecting the $174.6 billion in income and $48.4 billion of allowable foreign tax credits. But the main issue here is the composition of the $12.7 billion.\(^2\)

Desai and Hines effectively assume that all of the $20 billion of actual collections from foreign source income constitutes the residual tax on dividends. Their $10 billion of indirect efficiency loss arising from retained earnings is based on this erroneous assumption. For example, they state, “Conservatively, the $20 billion estimate can be increased by 50 percent, to incorporate the effect of taxes owed on unrepatriated earnings and the differing average rates of taxation on repatriated and unrepatriated income.” In fact, dividends account for a relatively small amount (no more than 15 percent) of current revenue. For the remainder, deferring income was not an option. Let us, therefore, look at how foreign income and the tax derived thereon are distributed.

Of the $12.7 billion residual tax in 2000, the U.S. tax on the largest income basket, for general nonfinancial active income, was $5.6 billion. Of this $5.6 billion collected, only about $1.3 billion is obtained from dividends. The vast majority of dividends bear no residual tax, because either the parent has excess credits or the dividend carries a credit greater than the 35 percent U.S. tax rate. That leaves only low–tax dividends received by parents without excess credits. The remaining $4.3 billion collected on the income in this basket arises from royalties and interest received from active affiliates, both of which are deductible from host country taxable income, as well as foreign branch income and export sales source income. Under the U.S tax rules, 50 percent of export sales income can be classified as

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\(^1\) The adjustments also include a recharacterization of foreign income as domestic because of earlier foreign losses. If a foreign loss offsets positive domestic income, then in subsequent years when foreign income becomes positive it has to be recharacterized as domestic to the extent of the previous loss. It, therefore, cannot be shielded by foreign tax credits. The intent is to prevent companies from using foreign losses to reduce U.S. taxes and then having positive foreign income shielded by credits. The 2000 data indicate that almost all of the adjustment is attributable to domestic losses.

\(^2\) I do not emphasize the discrepancy between the adjusted and unadjusted data, in part because the parent may have eventually been able to use its loss carryforwards against domestic income. Attributing all the benefit of the domestic loss to foreign income may, therefore, be inappropriate because of the asymmetry in the recharacterization of losses that was in place until the 2004 American Job Creation Act (AJCA). Foreign losses would lead to eventual recharacterization of foreign income, but domestic losses offsetting foreign income could not generate a recharacterization of domestic income as foreign where it might be shielded by tax credits. The main purpose of recharacterization rules is to make the tax result independent of the tax accounting period (two years versus the current one year, for example). If domestic income could not be recharacterized, companies might effectively lose the benefit of previous net operating losses.
Companies benefit from this provision because the export income can be shielded from U.S. tax by excess foreign tax credits, but a substantial share still remains taxable. Indeed, it accounts for $1.5 billion of the revenue in the nonfinancial active basket (more than dividends).

In the remaining $7.1 billion of U.S. residual tax, $4.6 billion was obtained in the financial services basket and $2.1 billion in the passive basket. Dividends account for even less of the revenue in the financial services basket—only $0.3 billion of the total tax of $4.6 billion. Much more important are branch income and the interest earned by U.S. financial institutions when they make loans to foreign borrowers from their U.S. offices. Total interest received was $58.9 billion, and branch income after ‘definitively allocable deductions’ but before deductions for interest expense was $39.3 billion. Neither of these revenue sources results from a repatriation–versus–deferral decision by U.S. multinational corporations (MNCs).

These data indicate a substantial portion (perhaps 25 percent) of the revenue collected on foreign income involves activities that are performed entirely in the United States, namely exports and foreign loans made from the United States.

Now, it might be argued that non-dividend income, such as royalties and interest, is in principle substitutes for dividends, so that starting with a figure closer to $20 billion (the 1999 figure before adjustments), or $12.7 billion (the 2000 figure after adjustments), is actually the correct starting point on which to base the indirect cost of repressed repatriations. But the approximate $1 billion efficiency loss estimates made in 2001 both by Grubert and Mutti (2001) and by Desai, Foley and Hines (2001), which are ignored in the paper, nevertheless remain valid. (They are described in greater detail below.) These estimates were based on dividend repatriation equations, which reveal how much tax companies are willing to pay to avoid having to retain a given amount of income. They are sufficient to capture possible substitutions with alternative payment vehicles.\(^3\)

**THE BURDEN ON COMPANIES FROM HAVING TO DEFER INCOME**

These data show that the starting point in the Hines–Desai estimate of the cost of deferring repatriations should be at most $2 billion, the actual current tax on dividends, not $20 billion. In addition, the authors rely on a highly artificial model of MNC behavior in discussing the cost to the companies of the current system. Desai and Hines cite the “prevailing theory of corporate dividends,” the “new view” applied by Hartman and Sinn to international tax, in saying that “deferral does not change the present value of repatriation taxes on current income.”\(^4\) This conveys the impression that, under this theory, the deferral privilege confers no benefit. That, of course, depends on the pre–tax rate of return companies can earn abroad and how long they can avoid repatriations. In the Hartman–Sinn model, the opportunities for avoiding repatriations and making profitable investments abroad are con-

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\(^3\) As noted in Grubert and Mutti (2001), the full welfare change may also depend on the current tax on the substitutes. But that would make the welfare cost even lower. It might be argued that the passive income that brought in $2.1 billion of revenue in 2000 is part of a deferral strategy and should be included with dividends to estimate the indirect costs of deferral. This will be discussed below. It might also be claimed that the subsidiary–versus–unincorporated branch decision is distorted by the current tax on branch income, particularly in banking. Regulatory considerations and cost of finance concerns are important in this choice. The mix of branches and subsidiaries in high– and– low tax countries would identify any tax effect. Any tax system will distort decisions along some margin. For example, exempting dividends and active branch income distorts the royalty–dividend choice.

strained because the subsidiary has only one alternative to repatriation—investing in its own operations. The subsidiary has to ‘underinvest’ initially because further investment in its own operations is the only way it can defer the U.S. tax. Once its capital expands to the point where its return after host country taxes just equals the MNC’s after–tax return at home, it repatriates all its earnings. At that point, deferring repatriations does not change the present value of taxation because the expansion of investment abroad has driven down its return.

The Hartman–Sinn assumptions about the alternative uses of earnings available to the subsidiary are very restrictive and limit its relevance. Any subsidiary has a much wider range of options for deploying its earnings, including investing in passive financial assets or in related affiliates in other countries. Altshuler and Grubert (2003) show that companies can use these options in straightforward strategies that offer the benefits of repatriation without actually triggering a tax.5 The simplest is Weichenrieder’s (1996) strategy under his assumption of company–level arbitrage in which interest rates are bid up above equity returns because interest is tax deductible. In that case, the subsidiary can invest in passive assets, and even after paying the current U.S. tax on the interest under subpart F, it would earn as much as it could at home. The tax on the principal, i.e., the initial profits from the operating assets, can be deferred indefinitely. If the Weichenrieder (1996) arbitrage assumption does not hold, a strategy that is almost as simple is for the parent to borrow using the passive assets abroad as informal or implicit collateral. The company can also engage in a variety of ‘triangular’ strategies using other subsidiaries that reduce or eliminate the repatriation tax. Finally, since the “check–the–box” rules introduced in 1997 greatly simplified the use of hybrid entities, companies have been able to magnify their observed foreign tax rates for the purpose of enhancing the foreign tax credits created by dividends.6 In summary, companies can defer repatriating indefinitely without large cost.

To be sure, these avoidance strategies are not entirely costless as Altshuler and Grubert (2003) assume in their model. The costs can be expected to depend on the amount of income that is retained and to vary among different companies. For any repatriation tax, the company has to compare the current tax if a dollar of earnings is repatriated with the present value of all future costs, including planning costs, foregone domestic opportunities and eventual tax payments if the dollar is ever repatriated. The greater the repatriation tax, the more likely it is the company will choose to incur the cost of tax planning. For the large pool of inframarginal retentions in which the costs of deferral are smaller than the repatriation tax, the present value of the repatriation taxes is smaller than the tax on the income if currently distributed.

This less artificial view of MNC strategies, therefore, leads to predictions different from Hartman–Sinn. Under Hartman–Sinn, dividend repatriations would not depend on the size of the repatriation tax once the company becomes “mature.” The same repatriation tax applies to both current dividends and future dividends paid out of retained earnings. But, contrary to Hartman–Sinn, Grubert and Mutti (2001) and Desai, Foley and Hines (2001)

5 Desai and Hines cite this paper, but ignore its implications in making their estimates.

6 In the foreign jurisdiction, the U.S. operating company is held by a partnership controlled by the parent. The partners are, therefore, responsible for the operating company’s tax liabilities. But the partnership is classified as a corporation for U.S. tax purposes. What the U.S. Treasury sees in that controlled foreign corporation is the entire tax paid for the operating company’s income, but income that only includes any dividend the operating company may distribute. The dividends the hybrid entity makes to the parent, therefore, can carry large credits. (See Peroni, Fleming, and Shay (2003).)
actually find a very strong negative relationship between dividend repatriation taxes and payout rates.\(^7\)

Furthermore, Altshuler and Grubert (2003) show that repatriation taxes do not create the “underinvestment” period that is required in the Hartman–Sinn model. Companies can immediately obtain the benefits of deferral because they have alternatives other than investing in their own operating assets. Subsidiary financial behavior is also consistent with their choice of strategies to reduce the burden of the repatriation tax. Finally, Desai and Hines’s own data in Figure 2 of their paper show that payout rates were declining even before the recent sharp drop in anticipation of the one year holiday in the American Job Creation Act (AJCA) in late 2004. This did not suggest that the large pool of retained earnings abroad was about to be repatriated anytime soon.\(^8\)

The evidence, therefore, supports the alternative to the Desai–Hines “prevailing theory” and, by implication, the efficiency cost of retentions estimated by Grubert and Mutti (2001) and Desai, Foley and Hines (2001). The Desai–Foley–Hines estimate based on a repatriation equation was 1.55 percent of affiliate net income, which translates into 1.2 percent of pre-tax income or about $2.0 billion at 2000 levels of income. This is very close to the 1.0 percent of pre-tax affiliate income estimated earlier by Grubert and Mutti (2001) using their own repatriation equation. Combining the actual tax payments and the efficiency cost of deferred payments, therefore, amounts to less than two percent of affiliate pre-tax income.\(^9\)

In summary, the $10 billion of efficiency cost that Desai and Hines now attribute to deferral is four to five times their estimate just three years ago, simply because they now seem to assume that 100 percent of the $20 billion that they estimate was collected from foreign income in 1999 was from dividends, rather than the 10 to 15 percent that is actually the case. In addition, they rely on a very restrictive model of subsidiary behavior that is not consistent with the evidence.

OVERHEAD DEDUCTIONS AND THE MEASURE OF INCOME

Any measure of income used to construct effective tax rates should be net
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of the expenses incurred in producing that income. The tax paid on that income should also reflect a bonus if the tax rate applicable to the deduction for the expense is higher than the tax rate applicable to the profits. The problem arises because of overhead expenses, such as interest and R&D, that are incurred by one member of the multinational group, but profit other members of the group. For example, a parent can borrow, deduct the interest at home, and then inject equity into a low-tax subsidiary whose equity income can be deferred. Similarly, the parent can engage in R&D that is deductible in the United States and transfer the results to its foreign affiliates. It is, therefore, necessary to make some assumption about the relation between worldwide overhead expenses and income in a particular location. Desai and Hines state that their burden calculation “leaves the taxation of domestic income unchanged.” This apparently innocent assumption arbitrarily distorts the analysis, because a bonus to foreign income is frequently in the form of lower taxable domestic income. Foreign business activity that does not bear the parent cost of the borrowing that finances it is an example. Effective tax burden estimates must recognize the obvious incentive for MNCs to stuff overhead expenses like interest in high-tax locations so that more of their taxable income can be reported in low-tax locations.

The Desai–Hines claim that no allocations of parent overhead expenses should be made to foreign income makes the implicit assumption that no foreign income is ever attributable to parent overhead expenses. In the important case of interest, that means that no parent debt is ever used to finance foreign investment. The basis for this assumption is never explained. The neutral assumption, in the absence of specific evidence, is that all assets worldwide can be financed with an equal percentage of debt, i.e., worldwide fungibility that has been adopted in the recently enacted AJCA. This is similar to any individual or domestic firm that can finance a certain proportion of their investments with debt. If the parent has more debt in relation to its assets than do its foreign affiliates, the assumption of worldwide fungibility requires that the debt in excess of the worldwide ratio is assigned to foreign income to calculate “true” foreign income.10

The question regarding the contribution of MNC overhead expenses to foreign operations is, in principle, an empirical one. The allocations of R&D to foreign income mandated by the 1995 regulations are modest because of some evidence that there are delays in applying new technology abroad (U.S. Treasury Department, 1995). Lower allocations of interest would be justified if there was evidence that increases in foreign assets are financed with less debt worldwide or that, in the absence of tax considerations, the debt is largely raised in the local market.

Desai and Hines are correct in stating that the pre–AJCA interest allocation system was overly harsh, although they overstate the case because they misinterpret the relevant arithmetic.11 The old “waters edge” system would allocate interest to foreign income even if foreign subsidiaries had debt–asset ratios equal to the debt–asset ratio of the parent company. But that

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10 This is no different from the case of banks and insurance companies, which have to pro-rate a certain amount of their interest expense to their investments in tax–exempt bonds. Even individuals cannot borrow and invest all their assets in tax–exempt bonds without losing deductions for their interest expense.

11 Desai and Hines assert that if the parent and affiliate each have an equal amount of operating assets, the parent will have to allocate 50 percent of its interest expense to foreign income irrespective of how much debt the affiliate has. That is incorrect. The “foreign assets” for this purpose are the parent’s equity, net of any affiliate debt. For example, assume each has 100 of operating assets and 50 of debt. Then the allocation of parent interest is 50/150, not 100/200 as Desai and Hines claim.
is only part of the story. Allocations in the present U.S. regime for taxing foreign income only affect the U.S. parent’s tax liabilities if it is in excess credit. They reduce the amount of allowable foreign tax credits. Parents in excess limit, which account for the majority of foreign income, are not affected. They are free to borrow, obtain a full tax deduction for the interest against U.S. taxable income, and finance their low–tax subsidiaries with equity, the income of which can be retained abroad.

All of these effects were taken into consideration in Grubert (2004), which estimated the various positive and negative components of the worldwide tax on the foreign income of U.S. manufacturing companies. It included both the penalty imposed on U.S. manufacturing abroad by the “waters edge” system and the bonus from parent debt that was in excess of the MNC’s worldwide debt–asset ratio. It turned out that in 1996, the “bonus” from parents’ excess debt was three times as large as the “penalty” imposed by the pre–AJCA allocation system.\(^\text{12}\) U.S. companies used debt to shift taxable income away from the United States.\(^\text{13}\)

OWNERSHIP NEUTRALITY

Desai and Hines attempt to provide an alternative to the way in which the choice of a guiding principle for international tax is usually framed, that is, between Capital Import Neutrality (CIN) and Capital Export Neutrality (CEN). They assert that the main issue is which company can make the most efficient use of assets in a location. They repeat the familiar criticism of the strict assumptions necessary for CEN, particularly that all U.S. foreign direct investment is financed by U.S. saving, so that any increased investment abroad has to be at the expense of U.S. domestic investment unless there is an equivalent increase in domestic saving. This critique is fair enough. It is difficult to deny the possible existence of portfolio inflows, such as foreigners buying U.S. shares, which could finance investment abroad if it were sufficiently profitable. It may, however, be too bold to jump to the other extreme of perfectly elastic portfolio flows, particularly in view of the extensive literature on “home bias” in portfolio choices.

In any case, some time ago Grubert and Mutti (1995) provided a simple, general framework for exactly this case of perfect portfolio mobility by applying standard second best theory. Not surprisingly, the case for a lower home country tax on a direct investment abroad depends on the cross–elasticities in demand between the goods produced by the subsidiary and goods produced in other locations, both high– and low–tax. For example, if tax haven production displaces production in a high–tax country, the case for a lower home country tax on the tax haven production is negated. In contrast, if the low–tax operation competes with other low–tax output, then a lower home country tax is justified. Responses in different locations and industries may vary depending on the intangible assets that the U.S. parent contributes to the foreign operation in the form of patents, trademarks, marketing programs, process innovations, etc.

Now, Desai and Hines do not consider any of these various possibilities. They

\(^{12}\) In 2000, all allocations of interest to foreign income reduced available credits by $2.3 billion. Grubert (2001) estimated that worldwide fungibility would reduce allocations by about two thirds, which would suggest a penalty of about $1.5 billion imposed by the “waters edge” system.

\(^{13}\) The marginal effective tax rate estimates in both Grubert and Mutti (2001) and Altshuler and Grubert (2001), which indicated that dividend exemption would raise the tax burden on investment in low–tax jurisdictions, assumed allocations to exempt income under worldwide fungibility, not waters’ edge. These marginal effective tax rate estimates, incidentally, also included the estimated efficiency loss from deferred repatriations based on Grubert and Mutti (2001), but also consistent with the similar estimates in Desai, Foley and Hines (2001).
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implicitly make the restrictive assumption that a U.S. MNC’s investment in a location does not affect its or another company’s investment in any other location. Thus, for example, if a semiconductor company designs a unique new chip and decides to produce it in a low–tax location, this will apparently not affect the production of chips in any other location. Presumably, this implies that the computer chip will be produced in all potential locations rather than the company being able to exploit economies of scale and produce it in a limited number of countries. Although Desai and Hines refer to intangible assets, their analysis clearly does not fit the case of mobile intangibles in which a valuable intangible can be used to produce goods in one location that are sold on the worldwide market. Because of the importance of mobile intangibles, investments in various locations now interact through the product market rather than through the limited supply of saving as in CEN doctrine. For Desai and Hines, firms compete only in a given location rather than in a given market, which may be localized for some goods and global for others.

The flaws in the Desai–Hines analysis are clear in each of the two alternative ownership neutrality options they present: National Ownership Neutrality (NON), in which national welfare is maximized, and Capital Ownership Neutrality (CON), in which worldwide efficiency is maximized. They claim that all foreign income should be exempt under NON, because the United States benefits when any further investment abroad yields a net profit. But this assumes that the transfer of any intangible asset abroad cannot reduce its use domestically. Desai and Hines claim that CON requires conformity among tax systems, including the universal exemption of all foreign income. But that would cause companies to make inefficient choices among alternative locations of production.

WHO GETS THE BENEFIT OF THE EXCESS CREDIT SPILLOVER TO ROYALTY AND EXPORT INCOME? ESTIMATING MARGINAL EFFECTIVE TAX RATES ON FOREIGN INVESTMENT

Desai and Hines refer to the benefit companies in excess credit get by their ability to use these credits to shield royalties and export sales income. They claim that the attribution by Grubert and Mutti (2001) of all of this benefit to foreign investment is much too strong because some may in fact encourage domestic activity. In fact, the Grubert and Mutti revenue estimate makes no such assumption; it simply calculates the implication of the common type of exemption system in which excess credits disappear and non–dividend income other than active branch income is fully taxed.

Let us, nevertheless, consider the impact of excess credits on the decision to invest abroad. The case of royalties is different from that of export income, so let us consider each in turn. Royalties are by far the most significant, so we take them first. Consider a “typical” new operation abroad established by U.S. companies. Investment in this context should include both tangible plant and equipment abroad and, in addition, the contribution of U.S. intangible assets, or “know–how.” The new investment abroad would presumably replicate existing investments in terms of their mix of tangible and intangible assets and the distribution of assets between high– and low–tax locations. It should also mirror present subsidiaries in repatriation

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14 Their own attempts to identify complementarity or substitutability among different members of the multinational group contradict this assumption. See Desai, Foley and Hines (2004).

15 The Balance of Payments data published by the U.S. Commerce Department indicate that, in 2003, license fees and royalties amounted to 20.4 percent of all direct investment income, including dividends, retained earnings, interest and royalties. It is much more significant for manufacturing investments.
behavior. Accordingly, the tax burden on this new investment abroad will reflect all the same benefits from excess credits that royalties now enjoy. All of the current role of spillover benefits to royalties will count in estimating the effective tax rate on a new operation abroad because the typical new investment will be a properly weighted average of investments of all types in all locations. (See Grubert (2004) for a discussion of the methodological issues in calculating marginal effective tax rates on direct investment, and the modeling of intangibles in particular.)

This is not to say that domestic R&D will not benefit from the non-taxation of royalties as well. It depends on what is changing on the margin, foreign investment or R&D. If a U.S. company expands R&D, it can expect that part of the return will be in the form of royalties from abroad where the technology may be exploited, and that these royalties will be able to absorb excess credits. (Exploiting the new intangible asset will presumably require new investments in tangible plant and equipment as well.)

The less significant case of export income is different because, unlike tangible and intangible assets abroad, exports and foreign investment are not linked together in the same way. For companies already in excess credit, the new investment abroad will not produce any useable new excess credits because the current level of export income has already absorbed all the excess credits it can. There is only a spillover benefit to exports if the investment is in a high-tax country and the company is in excess limit because they have more than enough export income to absorb any new excess credits from investment abroad. Thus, in the marginal effective tax rates in a low-tax country calculated in Grubert and Mutti (2001) and Altshuler and Grubert (2001), there is no benefit attributed to foreign investment to reflect the spillover of credits to export sales. Desai and Hines do not provide any coherent alternative method for computing marginal effective tax rates on foreign investment.

THE IMPACT OF COMPLETE EXEMPTION OF ALL FOREIGN INCOME

The final $20 billion of the Desai–Hines $50 billion dollar estimate is the increase in corporate profits that would result if all income now defined as foreign under U.S. tax law were exempt and, further, if there were no allocations of parent overhead expenses to this exempt income. This will result in very large (in absolute value) negative tax rates for foreign investments. On the expense side, U.S. companies will be able to borrow in the United States and inject equity into low-tax subsidiaries, obtaining a valuable deduction for the interest at home, but no inclusion anywhere for the income. Indeed, since interest received from subsidiaries would be exempt, U.S. parents could finance all their investment in high-tax countries with earnings stripping parent debt that is taxed nowhere. The only constraint would be usually ineffective host country thin capitalization rules. Because royalties would be exempt from U.S. tax while being deductible abroad, U.S. companies would have the incentive to skim off their most valuable intangible assets and exploit them in foreign locations to escape being taxed anywhere. There would be a huge incentive for investment in tangible capital abroad because it makes the shift in intangible income possible.

The Desai–Hines system would, therefore, recreate the soon-to-expire Section 936 system that used to apply to Puerto Rico, but it would now apply on a world-

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16 The decomposition of the overall tax on U.S. manufacturing income abroad in Grubert (2004) also does not attribute a bonus to foreign income from the export sales benefit.

17 Companies can achieve a similar result under current law using hybrid entities, but they cannot distribute the income back to the parent. Desai and Hines do not consider this planning device in their burden estimate.
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wide basis. (See Grubert and Slemrod (1998) for a description of the Puerto Rican system and the way in which the ability to shift intangible income creates negative effective tax rates.) Indeed, the Desai–Hines regime would be much more favorable than Section 936. Allocations of parent overhead expenses were required under the Section 936 rules. Further, after 1982, U.S. companies in Puerto Rico could shield only a portion of their intangible income from U.S. tax. Desai and Hines would make the exemption complete. Companies would not be restricted to a relatively high-wage, high-cost location like Puerto Rico. Even high-tax locations would be attractive alternatives because of the opportunities for stripping out exempt interest and royalties.

The repeal in the anti–abuse provisions in subpart F would cause the proliferation of reinvoicing operations in tax havens that would be used to shift income from high–tax countries, including the United States. These are now subject to current tax as a backstop to the transfer pricing rules. The exemption of export sales source income would, of course, trigger the World Trade Organization problems that the United States has just escaped from.

In summary, Desai and Hines are being uncharacteristically conservative in projecting only a 40 percent increase in foreign investment if their proposal were implemented. Companies would not be restricted to a relatively high-wage, high-cost location like Puerto Rico. Even high-tax locations would be attractive alternatives because of the opportunities for stripping out exempt interest and royalties.

The Conclusions

The Desai–Hines estimates are based on a misunderstanding of the data on the U.S. tax collections on foreign source income, such as the significance of dividends in the overall picture. They do not clearly define what corporate revenue is the result of operations abroad and they provide no coherent justification for assuming that no overhead expenses incurred by the parent ever benefit foreign operations. As a result, they start with the wrong measure of foreign income and the taxes paid on the income. Their misinterpretation of the data leads them to vastly overestimate the cost to the companies of deferring repatriations, and they rely on a simple model of MNC behavior that is not consistent with the evidence. Their overall burden measure is based on their view that foreign income of all types, including interest and royalties that are deductible abroad, should be exempt from U.S. tax. But this would put U.S. companies in a position much superior to that of any of their foreign competitors. Indeed, the full exemption of all foreign income would not reduce the tax burden on foreign investment to zero; it would constitute a huge subsidy to foreign investment, which would bear no parent expenses while facilitating the stripping of highly valuable intangibles out of the United States.

18 Desai and Hines do state in a footnote that they would not exempt “truly passive” income, but it is included in their $20 billion starting point. The 2000 data shows that it accounts for $2.1 billion of the $12.7 of revenue derived from foreign income.
Finally, it should be noted that many of the components of a valid estimate of the burden on foreign income, such as the “waters’ edge” system for interest allocation, have been eliminated in the American Job Creation Act of 2004.

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