U.S. CORPORATE INCOME TAXATION
AND THE DIVIDEND REMITTANCE POLICY OF
MULTINATIONAL CORPORATIONS

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Features of the U.S. taxation of the income of multinational corporations are shown to affect the minimum rate of return required on the unremitted profits of foreign subsidiaries. The article develops criteria that should be used by the firm as the minimum required return on reinvested earnings as the result of fiscal devices such as tax deferral, the foreign tax credit, and the special tax treatment of subsidiaries in less developed countries.

CONFLICT AMONG FISCAL POLICY OPTIONS

A nation’s policy towards the taxation of the foreign income of its citizens is important in that it may, at the margin, influence decisions to invest abroad and at home by its multinational corporations (MNCs). Tax effects might be observed in the geographic distribution of investment, the profit repatriation decision, and the accumulation of retained earnings in nations with low corporate income tax rates.

U.S. tax policy for corporations earning foreign income has been torn among several conflicting objectives: (1) external neutrality, (2) domestic neutrality, and (3) utilization of fiscal policy to act as an incentive for specified forms of activity.

A. External Neutrality

External neutrality would be reflected in policy by having foreign operations taxed at the same rate as competitors in foreign markets. Additional taxation by the U.S. would place such firms at a competitive disadvantage. The principle of external neutrality is best exemplified by the lack of Internal Revenue Code provisions before 1962, due partly to jurisdictional considerations, to tax income of controlled foreign corporations until their profits were remitted to the U.S. parent company. Except for 1962 legislative provisions to tax Subport F income when accumulated by a foreign subsidiary, the principle continues to hold today. If the foreign corporate income tax rate, $t_F$, is less than the U.S. rate, $t_{US}$, which is currently 48 percent, the foreign subsidiary will pay the foreign government tax at the rate $t_F$. It will pay no U.S. tax until the profits are remitted to the parent.

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B. Domestic Neutrality

The policy objective of domestic neutrality is exemplified by the system of tax credits provided for taxes paid to foreign governments. For income actually received by MNC parents of foreign subsidiaries, the domestic neutrality objective is enforced by taxing all income at the same total effective rate. The rate so defined is the combined percentage of foreign and U.S. taxes paid on original pretax profits. Consequently, except for subsidiaries receiving favored tax treatment, when dividends are remitted to the U.S. parent by a controlled foreign corporation, the U.S. parent will pay tax to the U.S. government at the rate of \((t_{US} - t_f)\) on the original pretax profits of the foreign subsidiary.

In order to assist in attaining the policy objective of domestic neutrality with respect to foreign subsidiaries taxed at a higher rate than the U.S. rate, Section 904 of the Internal Revenue Code provides the options of "overall" or "per-country" bases for the computation of the foreign tax credit. If the foreign tax rate on distributed income, \(t_f\), is greater than the U.S. tax rate, no credit would be given on a "per-country" basis for the foreign tax paid in excess of the U.S. tax liability. In such a case, the effective total tax rate would be \(t_f\) and not \(t_{US}\).

If an MNC has some subsidiaries which pay income tax at a rate lower than \(t_{US}\) and others which pay at a higher rate, then the "overall" basis for tax credit computation would offer advantages. The excess tax paid to governments with tax rates greater than the U.S. rate could still count in the foreign tax credit as long as there is a margin between the U.S. tax liability on foreign income and the foreign tax credit for subsidiaries in nations with tax rates less than the U.S. rate.

The aforementioned system of external tax neutrality on profits retained by the subsidiary and domestic neutrality on profits remitted to the parent generated substantial tax-avoiding behavior by MNCs. Many collected profits in holding companies in nations with extremely low tax rates and used these tax havens as centers for the reallocation of the profits among subsidiaries. In such a manner, all U.S. income tax could be avoided. The Tax Reform Act of 1962 largely eliminated this potential to accumulate without restriction overseas subsidiary profits. Income not related to sales or production within the country in which a subsidiary is located was deemed to be taxable by the U.S. as if it had been remitted to the U.S. parent. Also, Section 482 of the Internal Revenue Code gives the tax authorities substantial leeway in allocating profits among subsidiaries if transfer pricing or other techniques have been used to avoid taxes.

C. Tax Preferences

Neutrality as a fiscal objective may be replaced with preferences when public policy intends to motivate certain types of behavior by the private sector. As a result, certain tax privileges are offered in the Internal Revenue Code to Less Developed Country Corporations, Western Hemisphere Trade Corporations, U.S. Possessions Corporations, U.S. Virgin Islands Corporations, China Trade Act Corporations, Export Trade Corporations, and Domestic International Sales Corporations.