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# Taxing Multinational Enterprises: Basic Issues of International Income Tax Harmonization

Income taxation is an important factor in the economic planning and performance of a multinational enterprise, and consequently can be significant in regulating the operations of such enterprises. Multinational enterprises now devote considerable attention to compliance with and planning for the complex and often contradictory tax regimes in the countries in which they invest and do business. In recent years taxation of multinational enterprises has also received increased attention by national and international governmental bodies. Various groups within the United Nations, the Organization for Economic Cooperation and Development, the European Economic Community, and the United States Congress and Department of the Treasury are currently reviewing and developing guidelines for the taxation of multinational enterprises.[1] Principal among their considerations have been the identification and harmonization of conflicting income tax systems and goals. This article summarizes—without detailed technical analysis—the basic issues and approaches involved in such international income tax harmonization.

## The Impact of Multiple Taxing Jurisdictions

### *Source vs. Residence Taxation and Tax Neutrality*

Income that arises in one country and then flows to another country—business profits, dividends, interest, royalties and so forth—is generally taxed by

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[1]*See, e.g.*, "Guidelines for Tax Treaties Between Developed and Developing Countries," U.N. Doc. ST/ESA/14 (1974); "UN Proposals for the Regulation of Transnational Corporations," Special Study No. 59 (Am. Man't Ass'ns 1975); "Guidelines for Multinational Enterprises," Declaration on International Investment and Multinational Enterprises (OECD June 21, 1976); Price Waterhouse & Co., EEC Bulletin No. 19 (Nov. 1975); H.R. 10612, 94th Cong., 1st Sess. (1975). At preparation of this article, the referenced bill is being amended for further consideration by Congress.

both countries according to their respective laws. The source country claims the right to tax the income on the ground that the activities giving rise to the income occurred there, while the recipient's country claims the right to tax the income on the basis of the recipient's residence. If taxation by the two countries is not coordinated, a heavier tax burden may be imposed on such income than on domestic income, with a consequent decrease in foreign trade and investment. If, for example, a royalty payment having a source in Country A bears a 30% withholding tax in that country and is also subject to a 50% tax in the recipient's country of residence, the aggregate tax burden with respect to the payment will be substantially higher than if the payment originated and was received in the recipient's home country. Alternatively, lack of coordination may grant income from foreign trade or investment unintended tax benefits, where, for example, income is free from tax in both the source and residence countries. In either event, taxation induces a distortion of allocation of capital among countries.

Double taxation often arises from rational but competing concepts of tax neutrality in residence and source countries. Most countries seek to effect some form of tax neutrality with respect to foreign trade and investment, so that such trade and investment is neither encouraged nor burdened by their respective tax systems. On the one hand, a country such as the United States may wish to tax each of its citizens, residents and domestic corporations on its worldwide income in order to avoid creating a tax incentive in favor of foreign investment over domestic investment. On the other hand, other countries may wish to tax equally income from similar assets or activities in the same physical locale or source, even though worldwide taxation by another country will reach the same item of income. Many countries, including the United States, tax on both bases, with nonresidents generally subject only to source taxation.

*Source and Residence Definitions*

Even while two countries tax principally on the basis of the source of income, their rules for determining the source may differ so that both tax the same item of income. For example, certain countries regard the source of royalty payments as the residence of the payor, while other countries consider the source to be where the property giving rise to the royalty is used. In addition, an enterprise organized under one country's laws and managed in another country may risk treatment as a tax resident by both countries. However, in certain cases neither country's source rules may treat a specific item as having a local source, so that the payment may escape tax entirely. Certain countries, for example, have not taxed operations on their continental shelves on the theory that their taxing jurisdiction does not extend beyond the shoreline. Likewise the definition of a local establishment subject to source taxation often differs from country to country. In less likely circumstances, an enterprise may avoid tax residence in a country imposing worldwide taxation, and also may avoid taxation under source rules of countries from which it derives income.

*Double Taxation of Corporate Earnings*

Many domestic tax systems purposely impose double taxation on corporate profits distributed to shareholders—once at the corporate level and once at the shareholder level. Such taxation is traditional within the United States tax system, as well as that of many other countries. This form of double taxation may be mitigated by reducing or eliminating the second level of taxation on dividends distributed to corporate shareholders. Such rules postpone the double taxation of income remaining in corporate solution until dividends are paid to individual shareholders, and facilitate at least intercorporate capital transfers. However, this tax benefit often is not extended to dividends received from a foreign corporation, resulting in an additional tax burden on foreign trade and investment. Even where countries have adopted integrated tax systems for distributions to individual shareholders, nonresident shareholders are often denied the benefit of the refunds or credits which effect the amelioration of the tax burden on corporate earnings.

*Direct vs. Indirect Taxation*

The economic impact of double taxation or the avoidance of tax varies—at least theoretically—with the kind of tax involved. A tax imposed on net income, such as gross receipts less investment and operating costs, is generally a direct tax—one which the taxpayer is unable to pass on to his customer because he is unable to predict the precise amount of tax at the time of the transaction. For a multinational enterprise engaged in substantially the same types of transactions over several years in substantially the same economic environments, this theoretical assumption is often false since the enterprise can predict its ultimate taxation with a fair degree of accuracy based on prior experience, and adjust its receipts accordingly.

On the other hand, it is generally assumed that an indirect tax—such as a sales tax or a tax on value added at each step of the production of an item by succeeding enterprises—is passed on to the customer and not borne economically by the producers. If both local products and imports are subject to the same local indirect taxes, theoretically both products are economically neutral so far as a local customer is concerned. In the same manner, exported products should be subject to no indirect taxation in the country of production (or such taxes should be refunded at export) and subjected to such taxation only in the country of destination, so that the products will compete equally with local products subject to the same tax in the destination country. This assumption is questionable where, for example, production costs in the country of origin or transportation costs between the countries result in higher costs to the foreign manufacturer, so that he cannot pass on the full burden of indirect taxation in the destination country. The economic impact of multiple taxing jurisdictions, while often involving primarily direct taxes, cannot be so limited.

**Tax Incentives and Disincentives**

A country which taxes only local source income of its tax residents may provide a tax incentive to foreign trade and investment over domestic commerce to the extent tax rates abroad on the foreign activities are lower than domestic rates. A restrictive definition of tax residence also may permit a multinational enterprise to arrange its operations so that it is not currently taxable on foreign source income. For example, the United States generally has considered only those corporations organized in the United States to be taxable on their worldwide income. Accordingly, the use of foreign subsidiary corporations by United States enterprises generally defers the United States tax on foreign operations until the income is repatriated. In addition, a country which taxes the worldwide income of its tax residents may nevertheless provide tax incentives or disincentives to foreign trade or investment by eliminating, reducing or increasing its tax on certain types of foreign source income or activities.

International income tax harmonization is complicated further by unilateral tax incentives and disincentives which bear little or no relation to the sound economic performance of multinational enterprises and reflect instead unilateral moral standards or sociological goals. For example, tax penalties and the denial of tax incentives for enterprises participating in certain religious or national boycotts or in certain foreign payoffs, regardless of economic distortion, have been proposed in the United States. Likewise a temporary local employment increase in spite of comparative inefficiency may be sought by discouraging investment abroad by local employers.

Finally, certain countries seek to encourage investment from abroad by providing tax exemption or reduced taxation of such investment. Such benefits may be extended to local branches of foreign enterprises, or only to locally organized subsidiaries of such enterprises. However, the efficiency of such incentives may be impaired in the absence of a similar tax credit or reduction against the home country tax on the worldwide income of the foreign enterprise.

Such local tax exemption may also be employed by a tax haven country simply to attract the organization of local subsidiaries to do business or hold investments in other countries, with license and professional fees being the principal benefit for the haven.

**Transfer Pricing**

The lack of international tax harmonization may often be manipulated to the advantage of a multinational enterprise through pricing policies of related enterprises. By carefully arranging transactions between such related enterprises, high prices may be charged for goods and services flowing to an entity operating in a high tax country. For example, a subsidiary in a high tax country may be charged for raw materials at a price which greatly exceeds the market price for the materials or the price charged for the materials to other subsidiaries in lower or no tax jurisdictions. In this case, the subsidiary's high cost of goods sold reduces its taxable income. In other cases, a parent enterprise may lend funds to a subsidiary in a high tax country at high interest rates. The additional interest costs also reduce the subsidiary's taxable income.

In reverse situations, the income of enterprises in low tax countries may be purposely increased. For example, the enterprise may sell goods to a subsidiary in a lower or no-tax country at a low price, perhaps even at a price resulting in a loss for the selling enterprise. Or it may lend money or provide services to such a subsidiary at no cost. In these cases, taxable income in the high tax country is held down while the subsidiary with which the dealings take place reaps the profits.

**Tax Administration, Information And Enforcement**

The multiplicity of rules for the taxation of multinational enterprises is further complicated by the difficulties of administration in the various countries involved. Generally the level of sophistication shown in the administration of a national tax system reflects the relative economic development of the country. Developing countries simply cannot devote the same number and quality of personnel to the administration of their tax systems as do most developed countries. Accordingly many countries lack the information and expertise to administer effectively their tax systems in the same manner as, for example, the United States. In certain cases these variations in administration are easily exploited by taxpayers using low or no tax jurisdictions and local secrecy laws. In other cases, however, developing countries have reacted to their administrative problems by imposing a broad range of restrictions on investments from abroad, including high withholding taxes on payments flowing out of the country.

Further difficulties arise from the traditional reluctance of countries to provide local information or enforcement for the fiscal laws of another country. The consequent uncertain manner in which the tax laws of a particular country will be administered and enforced further distorts the flow of goods and capital among countries.

**Unilateral Approaches to Tax Harmonization**

The basic issues above underlie substantially all present and proposed approaches to the income taxation of multinational enterprises. Certain issues present contradictory goals so that one principle may compromise another. This is particularly obvious in choosing between the two basic principles of tax neutrality, or in adopting a tax incentive or disincentive rather than tax neutrality.

*Credit or Deduction for Foreign Taxes*

One basic unilateral approach to international tax harmonization is to grant a deduction from worldwide income or a credit against the home country tax on foreign source income for foreign taxes paid on such income by the multinational enterprise. A deduction provides only partial harmonization, since the home country tax is reduced by only a portion of the foreign taxes. In the case of the foreign tax credit, if the foreign tax rate is lower than the home country rate, only the excess of the home country tax over the foreign tax on the foreign income is payable to the home country. If the foreign tax rate is higher, the home country foregoes tax on the income. However, the credit generally is limited to the amount of home country tax on the foreign income with respect to which the foreign taxes are paid, so the credit does not affect home country tax on domestic income. The home country may require the income and credit limitation of each foreign country to be calculated separately, or may permit high and low taxes of various foreign countries to be combined and so averaged over all foreign source income. The home country may also permit excess foreign tax to be carried over for possible credit in a prior or subsequent year.

Certain countries grant a credit only for foreign taxes imposed directly on the enterprise, such as taxes on foreign branch operations and withholding taxes on investment income. Other countries such as the United States also allow an indirect credit for taxes paid by a substantially owned foreign corporation to the extent the previously taxed profits are distributed in the form of dividends to the parent corporation. The effect of the foreign tax credit, together with possible carryovers of excess credits to other years, is to subject the enterprise's foreign source income to total income taxes at least equal to the home country tax rate on domestic source income. Accordingly a tax incentive in favor of foreign over domestic investment is avoided.

However, double taxation often arises where an enterprise is required to compute taxable income in the country where foreign activities are carried on, in a different manner from the computation in the enterprise's home country. For example, the home country may require deductions for expenses such as start-up costs while the source country requires the capitalization of those expenses, i.e., disallows a current deduction for the expenses. This frequently occurs in the conduct of mineral operations. In other cases, the home country may permit the enterprise to consolidate the income and losses from its entire operations while the source country of a particular income item may not allow the use of losses arising outside that country. Similar problems also arise where home and source country rules differ as to the determination of gross income. The home country may require the enterprise to report income on the accrual basis while the source country may allow the enterprise to report income only when it is actually received. In all of these cases, under a system which employs the foreign tax credit to eliminate double taxation of foreign source income and limits the credit in proportion to the amount of the enterprise's foreign source income as computed under the home country's rules, double taxation may continue. For example, where the home country requires deductions which are not allowed in the source country, the home country's foreign tax credit for the income taxed in the source country will be greatly reduced.

A contrary example of the lack of tax credit harmony is the deduction in the home country of a foreign source loss by a multinational enterprise without a carryforward of the loss under foreign law to reduce further foreign income taxes. Hence foreign creditable taxes in both years may remain high although a home country deduction was also taken for the loss. However, in the United States the recapture of tax on such a foreign loss out of future foreign income by limiting the foreign tax credit on such income has been proposed.

Furthermore, from the viewpoint of a country which provides local tax exemptions or reduced taxation to encourage investment from abroad, the foreign tax credit is often defective in that the benefits of tax incentives accrue to the home country's treasury when the income is repatriated rather than to the multinational enterprise for which they were designed. One possible variation is to grant a home country credit not only for foreign taxes paid directly or indirectly by the enterprise, but for foreign taxes spared by the foreign country as part of its tax incentive program, i.e., a tax sparing credit. Another variation is the extension of a home country investment tax credit, or deductible investment allowance or investment reserve, to foreign investment by a multinational enterprise. In this case, as opposed to the tax sparing credit, the home country rather than the foreign country controls directly the amount of tax incentive.

*Exemption Method*

A second basic unilateral approach is to exempt all foreign source income from home country taxation, or apply reduced home country tax rates to such income. Certain countries use this method particularly where an establishment abroad is subject to foreign taxation, or a foreign subsidiary already subjected to foreign tax on its income remits dividends to the home country enterprise. In these cases, considerable attention is focused on the source of income so that losses or expenses which relate to exempted or reduced rate income are not charged against taxable domestic earnings. Tax neutrality is achieved in that the multinational enterprise is taxed by the foreign country substantially as are enterprises from other countries deriving income from similar assets or activities in the same physical locale or source. However, this method provides a tax incentive to foreign trade and investment over domestic commerce where the tax rates abroad on the foreign activities are lower than home country rates.

*Current Taxation of Subsidiary Earnings*

Toward the opposite extreme, the principle of current worldwide taxation of home country residents on the basis of their respective abilities to pay may be extended so that even the income of a foreign subsidiary when earned is taxable on an accrual basis to its shareholders in their home countries. For example, the United States, Canada and Germany have attempted to curb certain tax avoidance techniques by current taxation of domestic shareholders on certain types of undistributed income of foreign subsidiaries, particularly investment income and income generated by subsidiaries located in tax havens. Likewise current taxation to the trust grantor of income of certain foreign trusts created by United States persons has been proposed, as well as current taxation to United States shareholders of all foreign subsidiaries' income. Taxation on such an accrual basis does not produce tax neutrality as among various investors in the same physical locale or source, since their home country taxation may vary substantially. However, substantial tax neutrality between foreign investment and domestic investment in the home country may be achieved if a foreign tax credit is provided for foreign taxes paid directly or indirectly on the accrued income.

## Bilateral and Multilateral Approaches To Tax Harmonization

*Inadequacy of Unilateral Methods*

The unilateral relief of double taxation automatically introduces a considerable degree of international income tax harmonization. However, unilateral measures are inadequate to deal with certain important problems—technical limitations in the relief offered by national laws, the home country cost of bearing the principal tax loss where a foreign tax credit or deduction is used, high source country withholding taxes which lead to the loss of home country foreign tax credits, settlement of transfer pricing disputes, exchange of information and other matters.

The possibilities for reducing aggregate tax liabilities through transfer pricing have made such pricing the single most important issue in the taxation of multinational operations in recent years. The United States, for example, polices the charges imposed between related parties under "arm's-length" principles. Most other countries have adopted similar rules which, in general, require that related enterprises deal with each other as though they were unrelated.

The difficulty with the imposition of arm's-length standards on a unilateral basis is simply that two countries may disagree as to what is a proper arm's-length charge. Where income or deductions are redetermined by the tax authorities of one country, double taxation can occur if the other country does not make an offsetting adjustment. For example, if a parent enterprise in country A sells widgets to its country B subsidiary at $100 each, and the tax authorities of country A determine that the sale price should have been $200 each (thus increasing A's income by $100 per widget), double taxation results unless country B allows the subsidiary to increase its cost of goods sold to $200 (from the $100 actually paid). Absent agreement between countries A and B, there will be double taxation of the same income and, depending on the tax rates involved, the total tax may equal or exceed the income on the transaction. Ironically it is precisely where country B's tax on the subsidiary is significant, so that tax reduction by shifting profits to the subsidiary is unlikely, that the highest double taxation will result. Most countries are simply unwilling to forego an increase in tax collections because of the failure of another country to make correlative adjustments in respect of their redeterminations of income. Problems of this nature can only be solved through bilateral agreements between taxing jurisdictions.

*Bilateral Tax Treaties*

To resolve these questions effectively, many countries have entered into bilateral income tax treaties. The United States, for example, is a party to over 30 income tax treaties with other countries. Altogether, there are over 200 income tax treaties among the developed and developing countries of the world. The United States treaties, and the treaties of the other developed countries, generally follow the Draft Double Taxation Convention on Income and Capital adopted in 1963 by the Fiscal Committee of the Organization for Economic Cooperation and Development. This model treaty and most other bilateral income tax treaties generally establish rules for:

- the determination of income (including allowable deductions) for branch operations in a country conducted by residents of the other country;
- the kind of activities giving rise to taxation in a country;
- the reduction of withholding taxes on dividends, interest and royalties;
- the establishment of arm's-length pricing rules;
- the taxation of income from personal services;
- the allowance of foreign tax credits or the exemption of income from tax;
- the exchange of information and establishment of dispute settlement and enforcement procedures; and

• non-discrimination protection.

The number of bilateral agreements dealing with these matters is rapidly increasing, and for the near future they will form the basis of further income tax harmonization.

*Multilateral Agreements*

Tax harmonization on a multilateral basis is developing more slowly. The members of the European Economic Community have placed the harmonization of tax systems and rates—including a uniform system of value added taxes, and of integrated corporation and shareholder taxation—high on the agenda for future action, as cited above.

An equally important development is now taking place with regard to international tax enforcement. The growing network of bilateral income tax treaties have set the stage for a multilateral exchange of information among countries having tax treaties with each other, and in certain cases information is already being so exchanged. The recent "Guidelines for Multinational Enterprises" issued by the Organization for Economic Cooperation and Development, cited above, also state with respect to taxation that multinational enterprises should:

> (1) upon request of the taxation authorities of the countries in which they operate, provide, in accordance with the safeguards and relevant procedures of the national laws of these countries, the information necessary to determine correctly the taxes to be assessed in connection with their operations, including relevant information concerning their operations in other countries;
> (2) refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm's length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed.

While the guidelines are voluntary, they are likely to be adopted in whole or part by a number of multinational enterprises, and express the growing multinational interest in increased taxpayer information and monitoring of intercompany transactions.

Certain multinational groups have imposed new restrictions on investment and trade from abroad, including tax disincentives, such as those under the proposed Andean Investment Code.[2] However, the expanded activities of the Organization for Economic Cooperation and Development and the United Nations in international income tax harmonization, cited above, seem likely to encourage individual countries to focus more on the benefits of such harmonization for both national tax revenues and increased investment from abroad.

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[2]*See, e.g.*, Price Waterhouse & Co., "The Andean Common Market," Information Guide (Mar. 1974).

**Conclusion**

Clearly the accommodation of the basic issues of multiple taxing jurisdictions, tax incentives and disincentives, transfer pricing, and tax administration and enforcement must generate further unilateral, bilateral and multilateral approaches to the income taxation of multinational enterprises. A successful accommodation may also alter the emphasis of such taxation, for a basic goal of most national income taxation of multinational enterprises in recent years has been prevention of tax reduction or avoidance. For example, high withholding taxes attempt to offset administrative difficulties, transfer pricing which shifts profits to a low tax country is penalized by potential double taxation upon redetermination, and the mandatory allocation of expenses to foreign source income reduces the home country foreign tax credit on the income taxed at a lower home country rate.

However, where foreign tax rates commence to approximate or exceed the particular taxing country's rate, such prevention is less crucial. Furthermore, as export trade and foreign investment by a particular country become more nearly balanced or exceeded by important trade and investment from abroad, a tax rule mandating high export transfer pricing or allocation of substantial expenses to foreign source income conversely reduces the country's tax revenue on such inward trade and investment. Similarly, tax rules which may increase or accelerate the gain on a transaction due to a revaluation between two currencies will also increase or accelerate a tax loss on a devaluation. Accordingly a focus on economic neutrality in income taxation of multinational enterprises, rather than penalties or immediate tax maximization, may ultimately serve the interests of most countries.