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The IRS's Unlegislated Tax on Foreign-Source Income

Government officials regularly exhort American businesses to compete more vigorously in foreign markets. Yet when U.S. companies venture abroad, one of their biggest handicaps is the U.S. tax system. Uncle Sam's tax treatment of foreign-source income is capricious, stacked against U.S. taxpayers, and incredibly complex. Before criticizing U.S. businesses for not competing more effectively, government policy makers should realize that many of the most severe competitive difficulties are made in Washington.

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An example of government-made barriers to effective competition by U.S. businesses in the world marketplace is an IRS regulation, recently finalized and applying retroactively, that forces many U.S. businesses with foreign-source income to allocate part of their state income and franchise taxes to foreign-source income. Specifically, the IRS regulation requires U.S. corporations paying taxes to states that base their business taxes on the unified business theory (hence do not clearly exclude foreign-source income from tax) to allocate a pro rata amount of their state taxes against their foreign-source income. The regulation is an unlegislated, back-door increase in the federal income tax on the foreign earnings of these companies.

States that reach beyond their borders to tax the foreign-source income of U.S. companies do so illegally. The states are constitutionally restricted to taxing income attributable to in-state activities. Although many business people believe that states often violate this prohibition, the courts have generally rejected business challenges and ruled in favor of the states. The IRS's regulation says, in effect, that irrespective of whether the states are overstepping their legal boundaries when they tax foreign-source income, the federal government not only will not contest their behavior but will punish taxpayers further.

The part of the state's tax that is attributable to foreign-source income, the IRS holds, should not be deductible against the domestic income of the company, but should be deducted from the income the company, or its subsidiary, produces abroad. This subjects the company to a double tax whammy. For one thing, the state imposes an unconstitutional tax on the company's foreign earnings. For another, the federal government artificially increases the company's income subject to U.S. tax.

Instead of hitting U.S. businesses already under intense pressure from tough foreign rivals with this you lose—I win rule, the federal government should accept either of two theories. If states are operating legally and only taxing income from in-state sources, federal authorities should let taxpayers allocate all of their state taxes to domestic income. If states are casting their tax nets too widely, federal legislation should rein in the states and end their abusive practice. Under no circumstances should federal authorities use overtaxation at the state level to justify higher taxes at the federal level.

Institute for Research on the Economics of Taxation

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How does the IRS regulation boost federal income taxes? U.S. companies operating abroad usually pay foreign taxes on their foreign income. The companies are also liable for federal income tax on that foreign income because the U.S. tax system is based on worldwide income. To relieve the double taxation created by its worldwide approach, the U.S. government since 1918 has allowed companies to claim foreign tax credits for their income tax payments to foreign governments. Businesses cannot, however, claim foreign tax credits in excess of the U.S. income tax they owe on the foreign income.

In recent years, most aggressively with the Tax Reform Act of 1986, Congress and the Administration turned this restriction into a revenue raiser. They tightened the limitation in various ways in order to collect more taxes on the foreign-source income of U.S. companies. They forced businesses to break foreign income into numerous accounting baskets, each with a separate credit limitation. They also required businesses to obey many tax rules that arbitrarily shift income from the foreign to the domestic category. With less apparent foreign income, the amount of allowable foreign tax credits shrinks. The IRS's allocation rule for state income and franchise taxes is cut from the same cloth. By artificially decreasing foreign-source income for U.S. tax purposes, it pushes still more foreign tax credits into the unusable category.

As firms can claim and use less credits with respect to their foreign taxes, more of their income is taxed both at home and abroad. Suppose, for example, that a U.S. business with foreign-source income has to allocate $100,000 of state taxes against its foreign income for U.S. income tax purposes. Also suppose, as is very frequently the case, that the firm's usable foreign tax credits are already limited by the U.S. government's contrived definition of its foreign income. The IRS's allocation rule reduces the share of income attributed to foreign sources by another $100,000. It does not, of course, reduce the foreign-source income subject to foreign tax; foreign governments do not allow U.S. companies operating in their jurisdictions to claim deductions for U.S. state taxes. At a 34 percent U.S. tax rate, the domestic U.S. tax of the business goes up by $34,000; at the same time, the shifting of the income, for tax purposes, from the foreign to the U.S. jurisdiction reduces by $34,000 the allowable foreign tax credit for the taxes paid to the foreign government. Thus, the allocation regulation costs the firm $34,000 of usable foreign tax credits and boosts its federal income taxes by $34,000.

The IRS rule for allocating the state tax deduction raises the effective tax rate and tax-inclusive production expenses of companies doing business abroad compared to companies of other nations. As a result of that tax bias, U.S. companies are less likely to take advantage of foreign business opportunities, leaving them to companies of other nations. U.S. companies, suffering the extra tax costs imposed by the U.S. tax system, become less significant players in an increasingly global marketplace. When the tax policies set in Washington give the edge to foreign firms, the ultimate losers are the American people.

Congressman William M. Thomas (R-Cal.) has introduced legislation that would put a stop to this abusive tax rule. Rep. Thomas' bill (H.R. 1429) would allow U.S. businesses to deduct from U.S. income their payments for state and local income and franchise taxes. His bill is a sound and straightforward remedy for an egregious tax insult. To be sure, more thoroughgoing reforms might be even better. The IRS's position, indeed, highlights the need for federal legislation to bar opportunistic states from taxing businesses on their foreign-source income. More fundamentally, Washington might consider moving the federal tax system to a territorial approach under which U.S. taxpayers would pay U.S. taxes only on U.S. income. At one stroke, that would remove many of the tax handicaps that hold U.S. firms below their potential in foreign markets.

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