Highlights of GAO-09-934, a report to The Committee on Finance, U.S. Senate

September 2009

INTERNATIONAL TAXATION

Study Countries That Exempt Foreign-Source Income Face Compliance Risks and Burdens Similar to Those in the United States

Why GAO Did This Study

A debate is underway about how the United States should tax foreign-source, corporate income. Currently, the United States allows domestic corporations to defer tax on the earnings of their foreign subsidiaries and also gives credits for foreign taxes paid, while most other developed countries exempt the active earnings of their multinational corporations' foreign subsidiaries from domestic tax. The debate has focused on economic issues with little attention to tax administration. GAO was asked to describe for a group of study countries with exemption systems: (1) the rules for exempting foreign-source income, and (2) the compliance risk and taxpayer compliance burden, such as recordkeeping, of the rules. The study countries, selected to provide a range of exemption systems, are Australia, Canada, France, Germany, and the Netherlands. For these countries GAO reviewed documents; interviewed government officials, academic experts, and business representatives; and compared tax policies, compliance activities and taxpayer reporting requirements.

What GAO Recommends

Because changing the United States system of taxing foreign-source income is a policy decision, GAO is not making recommendations related to tax reform. GAO does recommend that the Secretary of Treasury annually report, using already available data, the revenue generated by taxing foreign-source corporate income. The Secretary agreed with our recommendation.

View GAO-09-934 or key components.
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What GAO Found

The study countries exempt some corporate income, such as dividends received from foreign subsidiaries, from domestic tax. However, the study countries tax other types of foreign-source income such as royalties.

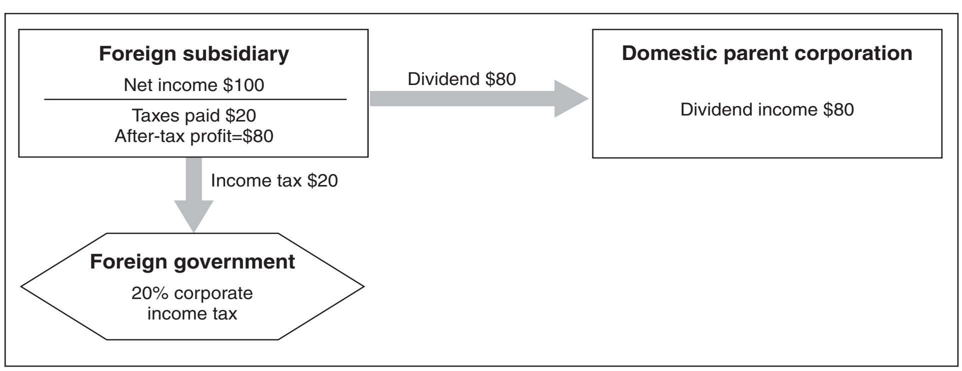
Multinational corporations present a compliance risk because they can use subsidiaries to convert taxable income into tax-exempt or lower taxed income, eroding the domestic tax base. Although quantitative estimates of noncompliance do not exist, tax experts interviewed by GAO identified sources of compliance risk and taxpayer burden in each of the study countries. These issues, particularly the ones below, have also been identified as sources of compliance risk and burden in the United States.

Transfer prices—the prices for transactions between related parties—can be manipulated to shift profits. Tax experts in the study countries said the growing importance of intangible property such as trademarks and patents is making international transactions more susceptible to transfer pricing abuse. In response, the study countries have all increased their scrutiny of transfer prices, including increased demands for documentation and more audits, resulting in increased compliance burden for taxpayers. Cooperative efforts between taxpayers and tax agencies to reduce audits, such as Advanced Pricing Agreements, received mixed reviews in the study countries.

Anti-avoidance rules prevent taxpayers from moving passive income (interest and royalties are often passive income) to a foreign subsidiary in order to avoid domestic tax. Generally, the rules make such passive income, even if moved, taxable. Tax agencies and taxpayers reported difficulties in obtaining information from other countries to make complex determinations about whether the anti-avoidance rules apply or not.

The United States does not report taxes paid on foreign-source income. Treasury officials said it would be feasible to do so. Such reporting would make more explicit the role international tax rules play in raising revenues and protecting the domestic tax base. All experts we spoke with on this topic agreed.

Simple Example of Dividend Exemption



Source: GAO.