STATISTICS OF INCOME STUDIES OF INTERNATIONAL INCOME AND TAXES: AN OVERVIEW

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This paper will briefly describe selected foreign and international area studies presently conducted by the Statistics of Income Division of the Internal Revenue Service. Most of the foreign area statistics prepared in these studies are for the Office of Tax Analysis in the Office of the Secretary of the Treasury, as well as for the staff of the Congressional Joint Committee on Taxation [1].

At the present time there are 13 studies with data tabulated from income tax returns and schedules filed by corporations, individuals, partnerships, estates and trusts. The majority of these studies deal with corporations, which is our focus here [2].

This paper will be separated into two segments; the first deals with the foreign activity of U.S. corporations, and the second describes the activity of foreign corporations in the United States and foreign interests in U.S. corporations, based on tax returns filed by these corporations.

International operations of U.S. corporations during the past twenty years have grown rapidly with overseas income making a substantial contribution to U.S. corporate total income and foreign investment accounting for a sizable portion of total investment by U.S. corporations. On the other hand, the investments of foreign firms in the U.S. during 1977 through 1981, although still not as large in dollar size as U.S. overseas investments, have increased at a more rapid rate. According to Department of Commerce data [3], foreign direct investment in the U.S. was $34.6 billion in 1977, and four years later amounted to $90.4 billion, a 161 percent increase. Foreign direct investment by U.S. firms during the same period increased 56 percent ($146.0 billion to $228.3 billion).

The growth of these investments (both domestic and foreign) and the movement of capital across international borders gives rise to competing tax claims. The United States generally taxes the income of its citizens on the basis of residence and source as do most countries [4].

FOREIGN ACTIVITY OF UNITED STATES CORPORATIONS

The first section of this paper presents an overview of three studies that deal with the foreign activity of U.S. corporations based on their tax returns. The first describes the special type of corporation called a Domestic International Sales Corporation (or DISC), and its trade activities compared to total U.S. domestic exports. Next is the Controlled Foreign Corporation study which presents data for foreign corporations controlled by U.S. corporations. These corporations represent a permanent establishment in the foreign country, as opposed to the DISC's. Finally, the corporate foreign tax credit study also gives an indication of the U.S. corporation involvement in foreign markets by measuring their foreign source taxable income and the amount of foreign tax credit claimed on their U.S. income tax returns.

Domestic International Sales Corporations -- American corporations wishing to engage in business activity abroad have many options -- one of these options is to form what is called a "Domestic International Sales Corporation" (or a DISC). This type of corporation was established by law in 1972. A system of tax deferral was set up so that only part of DISC profits were taxed to their shareholders (mostly U.S. parent corporations). The remaining profits could be deferred from tax indefinitely. The purpose of the law was to increase United States exports and make domestic products more competitive in the foreign markets.

From 1970 to 1972, United States domestic exports increased 15 percent, to $49 billion in 1972. After DISC's entered the picture, however, in 1972, domestic exports increased substantially reaching nearly $100 billion in 1974. They continued to rise through 1981 to $229 billion [5]. However, in 1982 and 1983, exports dropped because of recessions in other industrial countries, the financial problems encountered by lesser developed countries, the drop in world-wide oil sales affecting our exports to oil producing nations, and the rise in the value of the dollar making our exports more expensive, to cite some of the causes.

While data for DISC export activity is currently available through 1980, it seems probable that exports by DISC'S would be similarly affected after 1980, since Figure 1 indicates both

Figure 1.-- United States Domestic Exports and Exports by Domestic International Sales Corporations

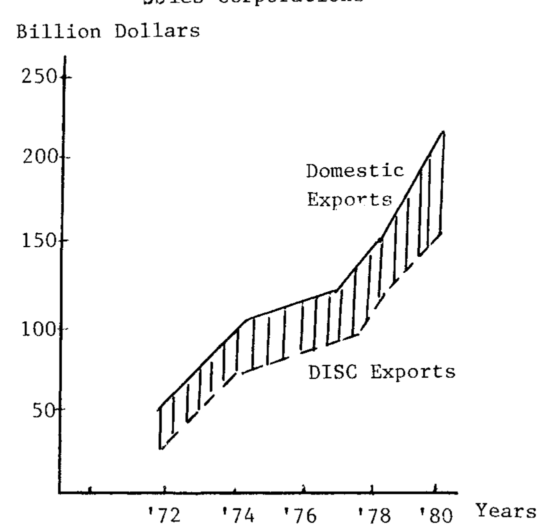


Figure 2. -- Number of Controlled Foreign Corporations and Selected Data for U.S. Corporation Returns and U.S. Corporation Returns with Total Assets of $250 Million or More, with Controlled Foreign Corporations, 1980
(money amounts are in thousands of dollars)

Selected Items	All U.S. Corporations	U.S. Corporations with Total Assets of $250 Million or More	Percent of Total
Number of U.S. corporation returns with CFC's	4,799	951	19.8
Number of CFC's	35,471	24,138	68.0
Total assets	508,032	477,828	94.1
Business receipts	699,003	652,490	93.3
Current earnings and profits (less loss) before taxes	47,622	44,502	93.4
Includable income of CFC's (Subpart F)	2,579	2,431	94.3
Foreign income taxes (net)	16,440	15,316	93.2
Distributions, total 1/	14,116	13,421	95.0
Dividends paid to U.S. parent corporations 2/	10,652	10,083	94.7

1/ Includes distributions out of other than earnings and profits.
2/ Only out of earnings and profits.

domestic exports and exports by DISC'S tend to move in the same direction and generally at the same rate.

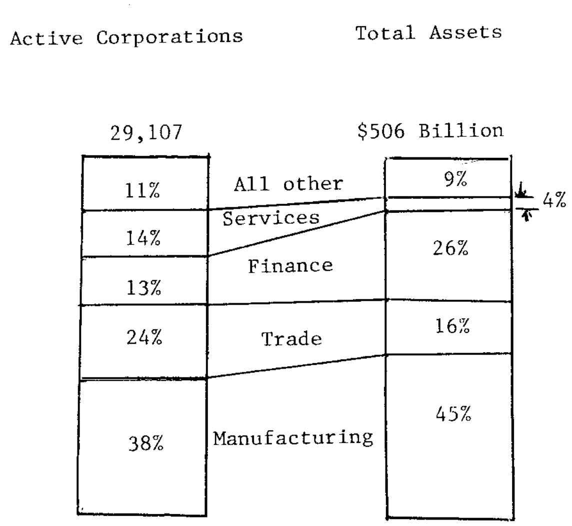
The "spread" shown in Figure 1 represented by the shaded area is the difference between domestic exports and DISC exports. These differences averaged $30 billion a year until 1978 when the amount of domestic exports each year began to exceed the annual increase of DISC exports until in 1980, the difference was $63 billion. The DISC legislation provided a one-time increase in exports through 1978, after which there was a small measurable DISC effect [6].

Controlled Foreign Corporations -- The most common method used by domestic corporations who engage in foreign activities is to establish subsidiary corporations in foreign countries. Such foreign subsidiaries, whose voting stock is more than 50 percent controlled by U.S. corporations, are referred to as "Controlled Foreign Corporations".

In 1980, Controlled Foreign Corporations numbered 35,471 and were controlled by 4,799 U.S. corporations filing their tax returns. The average total assets (a measure of investment) for these corporations more than tripled since 1962 when the data began to be tabulated indicating that the size of these corporations have increased relative to their number. (In 1962, there were 12,073 CFC's with an estimated $46 billion of assets. For 1980, the 35,471 CFC's had assets of $508 billion.) It indicates, in part, that the size of the initial foreign investment has increased so that, for the most part, only the larger U.S. corporations can afford to invest abroad, whether by internal (the U.S. corporation supplies its own funds) or external sources (the funds needed are borrowed abroad). Thus, Figure 2 shows that for 1980 over 90 percent of the assets and profits earned abroad of these foreign corporations were controlled by "large" U.S. corporations.

Of the total, 29,107 foreign corporations were actively engaged in a trade or business, the remainder merely represented a presence in the foreign country. Figure 3 shows that nearly 90 percent of the number of active foreign corporations were actively engaged in either manufacturing, trade, financial, or service activities, and they also accounted for slightly over 90 percent of the total assets. Manufacturing firms led all other industries in

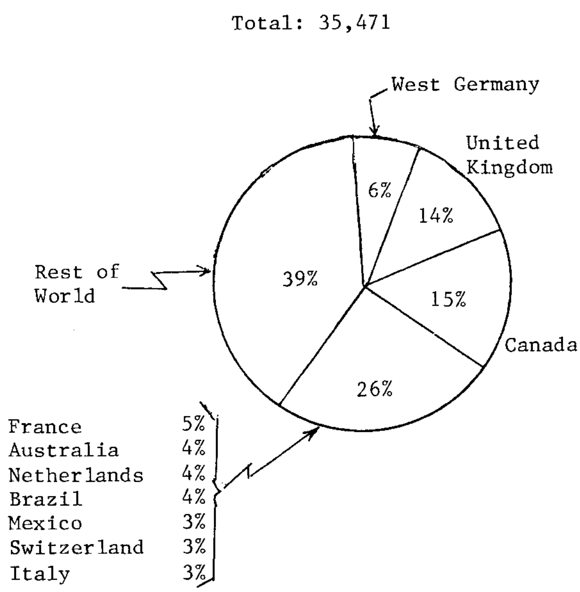
Figure 3. --Distribution of Active Controlled Foreign Corporations by Selected Industry and Assets, 1980



both number and assets; however, their relative importance has declined because of the more rapid growth of financial and service corporations in recent years.

Figure 4 portrays the most popular locations where these corporations were established. It should be pointed out that some corporations are established in one country and do business principally in another country, but our studies indicate that over 90 percent of them conduct their business in the same country in which they were organized. The countries shown in Figure 4 represent the top ten countries of the world that domestic corporations were inclined to establish a base for foreign operations [7]. Canada is the favorite location of American companies engaged in foreign activity. These Canadian companies accounted for 15 percent of the total number and nearly one-fifth of total assets of all these foreign corporations in 1980.

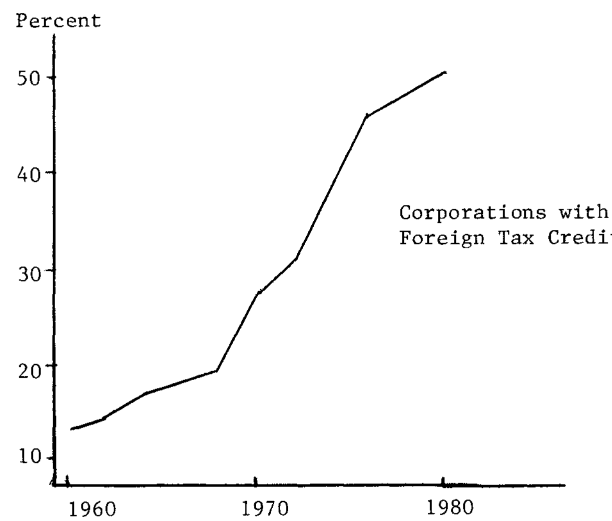
Figure 4. --Distribution of Controlled Foreign Corporations in the World, 1980



Corporate Foreign Tax Credit -- One indicator showing the involvement of American corporations in foreign markets is the amount of "Foreign source taxable income" reported by corporations eligible to claim a foreign tax credit on their tax returns [8]. This foreign taxable income primarily consists of profits earned by their "branches" in foreign countries, and dividends distributed to them by their subsidiary foreign corporations. It also includes income received from foreign sources such as rentals, royalties, interest, and compensation for services performed.

Foreign source taxable income for corporations with foreign tax credits, rose from nearly $3 billion in 1960, to over $70 billion in 1980. During the same period, the total United States taxable income (which is the basis for computing tax liability) reported by these corporations also increased by $118 billion to $138.6 billion. Although the amount of foreign source taxable income is substantial, some understatement does exist. U.S. corporations with deficits, (domestic losses off-setting foreign source income), are not eligible to claim the foreign taxes paid that year (although available for other years). In spite of the understatement, taxable income reported by corporations with foreign tax credits was nearly 60 percent of the taxable income for all U.S. corporations.

Figure 5. --Foreign Source Taxable Income as a Percent of Total Taxable Income



Using the amount of taxable income reported by domestic corporations that claimed a foreign tax credit, a percentage of the portion that foreign source taxable income contributed to the total taxable income can be derived. That percentage is plotted for certain years in Figure 5. It reveals that the percentage increased from 13 percent in 1960 to over 50 percent in 1980, indicating the overall growing importance of foreign activity engaged in by domestic corporations.

Generally, domestic corporations are subject to tax on their worldwide income. When part of that income is earned in foreign countries, the income may also be subject to tax in that country. In order to prevent double taxation of the same income, United States law permits corporations to claim a credit (or a deduction) thereby reducing their income tax for the taxes paid to the foreign country. In effect, the corporation pays the higher of the United States tax rate or the overall foreign country tax rate on its foreign source income.

Figure 6 shows the growth of the foreign tax credit claimed by corporations during the past 55 years. From 1925 until 1960, foreign tax

Figure 6. -- Growth of the Corporation Foreign Tax Credit, 1925 - 1981 (millions of dollars)

Tax Year	Foreign Tax Credit Claimed	Tax Year	Foreign Tax Credit Claimed
1925.....	20	1965......	2,616
1930.....	29	1970......	4,549
1935.....	32	1972......	6,315
1940.....	58	1974......	20,753
1945.....	96	1976......	23,579
1950.....	464	1978......	26,357
1955.....	959	1980......	24,880
1960.....	1,224	1981......	21,829

credit rose steadily from a level of $20 million to one and a quarter billion dollars. The decade of the sixties shows an increase in the credit nearly three times greater during this decade alone as compared to the preceding 35 years.

The foreign tax credit rose to record levels ($37 billion in 1979) during the decade of the seventies. The $32 billion increase in this ten year period was affected by such events as the OPEC induced rise in petroleum prices, and increased foreign activity of U.S. corporations.

The decade of the eighties, on the other hand, unlike the sixties and seventies, began with a decline in the amount of foreign tax credit claimed. The decline for 1980 and 1981 in the credit resulted from the foreign nationalization of certain oil interests in the Middle East. Corporations involved in oil related activities play a major role in the foreign tax credit. The use of the tax credit for certain foreign income taxes was not allowed; requiring the use of a tax deduction instead, which reduced foreign earnings--and when coupled with lower corporate profits, the amount of foreign tax credit eligible to be claimed was adversely affected--declining to $22 billion in 1981 [9].

ACTIVITY OF FOREIGN CORPORATIONS AND INTERESTS IN THE UNITED STATES

This section of the paper deals with the activity of foreign corporations in the United States. Two sources of IRS information will be used: (1) data on U.S. branch operations of foreign corporations; and (2) data on U.S. domestic corporations that are 50 percent or more owned by foreign interests. Taken together both sources have recently shown sharp increases in foreign operations in the United States.

Foreign Corporations with Income Derived from U.S. Sources -- For those foreign corporations engaged in a trade or business in the United States only that income which is "effectively connected" with the U.S. trade or business is tabulated and included in these statistics [10].

In terms of the amount of business conducted in the United States by these foreign companies --using total receipts as a guide--most of the income was received by banks--primarily interest income. Figure 7 compares the total receipts and number of these type of foreign corporations engaged in U.S. business operations for 1977 and 1981, as well as the principal business activity accounting for the largest percentage of total receipts and number of corporations in 1981.

In 1977, the total receipts of foreign banks operating in the United States accounted for 22 percent of all receipts of these foreign corporations and jumped to 68 percent in 1981, indicating the significant growth of foreign banking interests. (For example, in 1978, some 50 foreign bank branches operated in Chicago handling overseas investments coming into the United States.) While the receipts of banks went up during the period, the number of banks as shown in Figure 7, accounted for only 2 percent of the total number of foreign corporations. Thus, the relatively few foreign banks tended to have large operations in the United States.

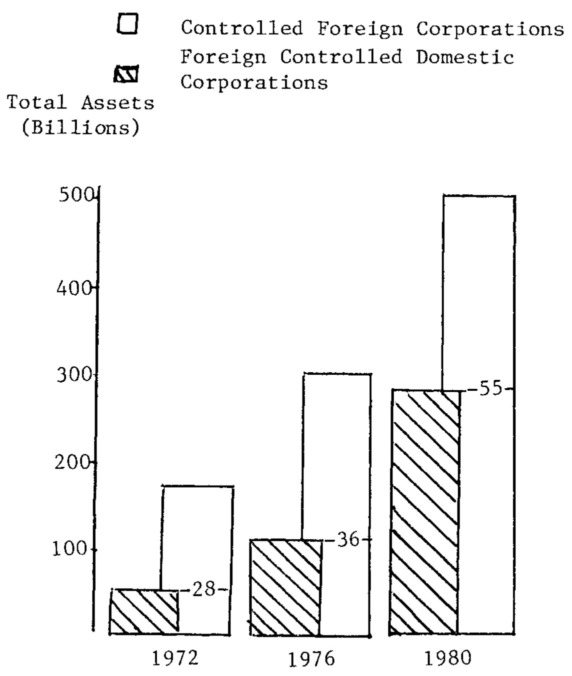
Figure 7. -- Number and Total Receipts of Foreign Corporations Engaged in Banking and Real Estate Activities in the United States, 1977 and 1981

Foreign Corporations	1977	1981
Total number...............	3,093	9,350
Banking corporations.....	131	207
Real estate corporations.	1,462	5,658
(millions of dollars)		
Total receipts.............	10,398	37,281
Banking corporations.....	2,654	25,374
Real estate corporations.	257	1,242

The same figure also shows that numerically, real estate companies operating in the United States for their foreign owners dominated the numbers. While we cannot discuss information filed with the I.R.S., public sources of information show, for example, that during the seventies, the oil sheiks of Kuwait bought and developed real estate interests in Atlanta, the Kiawa Island off the coast of South Carolina, and in downtown Boston. In addition, statistics from the Department of Commerce show that for 1977, foreign investors spent $3.8 billion on land and commercial properties located in the United States [11]. Therefore, it is not surprising to see that the number of foreign corporations with real estate interests in the United States increased in number so that 60 percent of the foreign corporations with income effectively connected with a trade or business in the United States in 1981 were principally engaged in real estate.

Domestic Corporations Controlled by Foreign Corporations -- The most common method used to establish a business in the United States is to acquire an equity in an existing American corporation. In addition, a joint venture can be another means to establish a business interest in the United States. Therefore, these domestic corporations can be considered as the "flip" side of the Controlled Foreign Corporations previously mentioned. Using the growth of total assets for both types of corporations, as shown in Figure 8, the total assets of Controlled Foreign Corporations is greater than the total assets of the "Foreign Controlled Domestic Corporations". The size of the foreign interest in domestic corporations is however, catching up--increasing to 55 percent of Controlled Foreign Corporations assets in 1980 from 28 percent in 1972. This increase in U.S. investment by foreign investors is also supported by the Department of Commerce's foreign investment statistics showing that the rate of growth of foreign claims on United States affiliates is higher than that of United States claims on foreign affiliates [11].

Figure 8. --Growth of Controlled Foreign Corporations and Foreign Controlled Domestic Corporations



CONCLUSION

A brief description has been provided on some of the foreign studies conducted by the IRS with a focus on investment abroad and foreign investment in the U.S. as reported on corporate tax returns. International operations of U.S. corporations and its effect on profits and taxes has grown significantly. Investment by foreign firms in the U.S. has become even more significant during the past decade than investment abroad. Thus, we can agree with Mr. Friedrichs (head of the German Chamber of Commerce in Chicago) when he stated in an issue of U.S. News and World Report that "The money goes where it brings the most return. There was a time when Americans bought almost all of Germany. Now the money is "flowing back" [12].

ACKNOWLEDGMENTS

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NOTES AND REFERENCES

[1] The SOI Division is responsible for the completion and publication of statistical data with respect to the operation of the tax laws for users inside and outside the government.

[2] For a brief description of all of the studies, see Gianelos, Arthur, and Hobbs, James, "Statistics of Income Studies of International Income and Taxes: A Brief Description of the Studies," Statistics of Income and Related Administration Record Research: 1984, Department of Treasury, Internal Revenue Service, October 1984. This is available upon request.

[3] U.S. Bureau of Economic Analysis, Department of Commerce, Survey of Current Business, August 1984, and earlier issues.

[4] See Carlson, George, International Aspects of Corporate-Shareholder Tax Integration, Office of Tax Analysis Paper 40, July 1980. A description of the "separate entity system" and "integration system" of tax is presented. An additional issue raised by the growth and influx of foreign investments both here and abroad is the "unitary tax". This tax is imposed on worldwide profits of foreign corporations by certain States. Although the issue of whether unitary combination should be applied on a worldwide basis is avoided, the discussion and tests applicable to domestic groups of corporations may apply in principle to affiliated members of multinational companies. See McClure, Charles, Jr., "Defining a Unitary Business: An Economist's View," N.B.E.R. Digest, October 1983.

[5] U.S. Bureau of the Census, Highlights of U.S. Export and Import Trade, FT 990 monthly.

[6] See also, Department of Treasury, The Operation and Effect of the Domestic International Sales Corporation Legislation, 1978-1981 Annual Reports.

[7] These countries were also the top ten countries in 1972 as well as in 1980 accounting for 65 percent of the total number of foreign corporations.

[8] A credit for income taxes paid to foreign governments is available to the U.S. corporation. The foreign tax credit is limited to the smaller of the actual foreign taxes paid or the portion of the U.S. income tax related to the foreign source taxable income. The purpose of the

limitation is to prevent foreign taxes from reducing U.S. taxation of domestic source income. Presently the limitation on foreign tax credit is determined by the ratio of taxable income from foreign sources to total taxable income, times the U.S. tax. The actual foreign tax credit cannot exceed the computed limitation. This method combines all foreign income allowing an "averaging" of high and low foreign tax rates. Any reduction in foreign source taxable income will reduce the limitation.

[9] Foreign tax credit continued to decline in 1982 to $18.3 billion according to preliminary estimates from corporation income tax returns.

[10] Income considered "effectively connected" with trade or business in the United States is subject to tax in the same manner as a domestic corporation is taxed. Income received from U.S. sources by foreign corporations that is not "effectively connected" with a trade or business in the United States is subject to U.S. tax generally at the rate of 30 percent on that income, and is not included in the statistics.

[11] As of the end of 1981, foreign direct investment in U.S. business had a book value of $90.4 billion and nearly all of it was represented by stock in, retained earnings of, and loans to U.S. subsidiaries. See Howenstein and Fouch, "Foreign Direct Investment in the United States in 1981", Survey of Current Business, Volume 62, Number 8, August 1982.

[12] "Foreign Investors Go on a Spree in the U.S.", U.S. News & World Report, September 24, 1978, page 53.