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The effect of the tax reform act of 1986 on the location of assets in financial services firms

Rosanne Altshuler[a,*], R. Glenn Hubbard[b]

[a] *Rutgers University, Department of Economics, 75 Hamilton Street, New Brunswick, NJ 08901-1248, USA*
[b] *Columbia University and the National Bureau of Economic Research, New York, NY 10027, USA*

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Abstract

This paper examines the effects of the Tax Reform Act of 1986 on the international location decisions of U.S. financial services firms. The Act included rule changes that made it substantially more difficult for U.S. firms to defer U.S. taxes on overseas financial services income held in low-tax jurisdictions. We use information from the tax returns of U.S. corporations to examine how local taxes affect the allocation of financial assets held abroad by financial services firms. We find that, before the Act, the location of reported assets in financial subsidiaries was responsive to differences in host country tax rates across jurisdictions. However, after the Act, differences in host country tax rates no longer explain the distribution of assets held in financial services subsidiaries abroad. Our results suggest that the tightening of the anti-deferral provisions applicable to financial services companies has been successful in diminishing the effect of host country income taxes on asset location decisions.

Keywords: Multinational; International taxation; Investment policy; Financial services; Tax Reform Act of 1986

JEL classification: H25; H32; H87

*Corresponding author. Tel.: +1-732-932-7783; fax: +1-732-932-7416.
E-mail addresses: altshule@rci.rutgers.edu (R. Altshuler), rgh1@columbia.edu (R.G. Hubbard).

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1. Introduction

The Tax Reform Act of 1986 (hereafter TRA'86) significantly changed the tax environment faced by U.S. firms with operations abroad. One interesting by-product of the Act is its widening of the gap between the treatment of income earned by financial service subsidiaries of U.S. multinationals and income derived from manufacturing operations. Among other changes, the Act made it substantially more difficult to defer U.S. taxes on overseas financial services income of U.S. firms. In this paper we investigate whether this 'tightening' of the anti-deferral rules affected the location of reported financial assets held abroad in U.S. financial affiliates.

Under U.S. tax law, income earned by U.S. firms in foreign jurisdictions is subject to U.S. taxation.[1] However, the active income from foreign operations that are organized as subsidiaries is not subject to U.S. taxation until it is repatriated to the U.S. parent corporation. The ability to defer U.S. tax liabilities on foreign-source income creates incentives for firms to locate operations in low-tax, or tax haven, jurisdictions. The 'Subpart F' provisions of the tax code, enacted in 1962, are designed to hamper the ability of firms to avoid U.S. taxes on international income permanently by retaining it abroad in low-tax countries. As we explain further below, changes made in 1986 to the Subpart F provisions essentially eliminated deferral on active financial services income. These rule changes were not applied to other forms of active income. As a result, TRA'86 created an environment in which the tax incentive to locate operations in low-tax jurisdictions depends on the 'type' of active income the subsidiary is expected to generate. After TRA'86, there is still a tax advantage to locating manufacturing operations in low-tax countries since these operations generate active income that enjoys deferral. However, this tax incentive was greatly diminished for subsidiaries that generate relatively large amounts of active financial services income.

The policy changes in TRA'86 targeted at financial services income provide an opportunity to examine how the location decisions of U.S. multinational corporations respond to taxation. In particular, we use information from the tax returns of U.S. corporations for 1984, 1992, and 1994 to examine how local taxes affect the allocation of financial assets held abroad in financial services firms before and after the Act (International Monetary Fund, 1984, 1992 and 1994). We focus on the hypothesis that, by effectively eliminating deferral on active financial services income, TRA'86 diminished any role played by host taxes in influencing the location decisions of U.S. firms with financial subsidiaries abroad.[2] Our results are

[1] See Hines and Hubbard (1995) for a brief summary of U.S. tax policy towards multinational corporations.

[2] Other provisions of TRA'86 also have the effect of decreasing the importance of local tax rates for the location of assets in financial subsidiaries. These rule changes, which modify the calculation of the tax credit U.S. firms are allowed against U.S. tax liabilities for taxes paid to host countries, are discussed in the next section.