Key Elements of the U.S. Tax System

How does the current system of international taxation work?

Q. How does the current system of international taxation work?

A. All countries tax income earned by multinational corporations within their borders. The United States also imposes a minimum tax on the income US-based multinationals earn in low-tax foreign countries, with a credit for 80 percent of foreign income taxes they've paid. Most other countries exempt most foreign-source income of their multinationals.

TAXATION OF FOREIGN-SOURCE INCOME

Following the 2017 Tax Cuts and Jobs Act (TCJA), the federal government imposes different rules on the different types of income US resident multinational firms earn in foreign countries (table 1).

- Income that represents a "normal return" on physical assets—deemed to be 10 percent per year on the depreciated value of those assets—is exempt from US corporate income tax.
- Income above a 10 percent return—called Global Intangible Low Tax Income (or GILTI)—is taxed annually as earned at half the US corporate rate of 21 percent on domestic income, with a credit for 80 percent of foreign income taxes paid. Because half the US corporate rate is 10.5 percent, the 80 percent credit eliminates the GILTI tax for US corporations except for any income foreign countries tax at less than 13.125 percent. After 2025, the GILTI tax rate increases to 62.5 percent of the US corporate rate, or 13.125 percent, which makes US corporations subject to GILTI tax only on income foreign countries tax at less than 16.406 percent.
- Income from passive assets, such as bonds or certain categories of easily shiftable assets, is taxable under subpart F of the Internal Revenue Code at the full 21 percent corporate rate, with a credit for 100 percent of foreign income taxes on those categories of income.

US companies can claim credits for taxes paid to foreign governments on GILTI and subpart F income only up to their US tax liability on those sources of income. Firms may, however, pool their credits within separate income categories. Excess foreign credits on GILTI earned in high-tax countries, therefore, can be used to offset US taxes on GILTI from low-tax countries. US companies may not claim credits for foreign taxes on the 10 percent return exempt from US tax to offset US taxes on GILTI or subpart F income.

How does the current system of international taxation work?

TABLE 1

Taxation of Foreign-Source Income of U.S. Multinationals

Type	2018-2025	2026 and after
Normal returns (10% of depreciable basis of tangible capital)	No U.S. corporate income tax.	No U.S. corporate income tax.
GILTI (intangible profits, defined as profits in excess of 10% of tangible capital)	10.5% U.S. tax rate with credit for 80% of foreign income taxes paid, up to a foreign income tax rate of 13.125%.	13.125% U.S. tax rate with credit for 80% of foreign income taxes paid, up to a foreign income tax rate of 16.406%.
Subpart-F income (passive and certain easily shift-able income)	21% U.S. tax rate with credit for 100% of foreign income taxes, up to the US tax rate.	21% U.S. tax rate with credit for 100% of foreign income taxes, up to the U.S. tax rate.

Suppose, for example, a US-based multinational firm invests $1,000 in buildings and machinery for its Irish subsidiary and earns a profit of $250 in Ireland, which has a 12.5 percent tax rate. It also holds $1,000 in an Irish bank, on which it earns interest of $50.

- The company pays the Irish government $31.25 of tax on the $250 of profits earned in Ireland plus another $6.25 on the $50 of interest from the Irish bank. Overall, it pays $37.50 of Irish tax on income of $300.
- The company owes no tax to the United States on the first $100 of Irish profits (10 percent of invested capital). It owes a tax before credits of $15.75 on the $150 of GILTI ($250 of profit less the $100 exempt amount). It owes $10.50 (21 percent of $50) on the interest from the Irish bank. So, overall its US tax before credits is $26.25.
- The company can claim a foreign tax credit of $21.25 from its Irish investments. This consists of $15 from the Irish tax on GILTI income (80 percent of .125 × $150) and the full $6.25 of Irish tax on interest income.
- So, overall, the US company pays $37.50 of tax to Ireland and an additional $5.00 to the United States ($26.25 less the $21.25 foreign tax credit) for a total tax liability of $42.50. This can be broken down into
  - $12.50 of Irish tax on the first $100 of profits from the investment;
  - $18.75 of Irish tax plus $0.75 of net US tax on the $150 of GILTI; and
  - $6.25 of Irish tax plus $4.25 of US tax on the $50 of interest income.

TCJA also introduced a special tax rate for Foreign Derived Intangible Income (FDII)—the profit a firm receives from US-based intangible assets used to generate export income for US firms. An example is the income US pharmaceutical companies receive from foreign sales attributable to patents they hold in the United States. The maximum rate on FDII is 13.125 percent, rising to 16.406 percent after 2025. FDII aims to encourage US multinationals to report their intangible profits to the United States instead of to low-tax foreign countries.

Most countries, including all other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom), use a territorial system that exempts most so-called “active” foreign income from taxation. Still others have hybrid systems that, for example, exempt foreign income only if the foreign country’s tax system is similar to that in the home country. In general, an exemption system provides a stronger incentive than the current US tax system to earn income in low-tax countries because foreign-source income from low-tax countries incurs no minimum tax.

Many countries also have provisions, known as "patent boxes," that allow special rates to the return on patents their resident multinationals hold in domestic affiliates.

Most other countries, however, also have rules similar to the US subpart F rules that limit their resident corporations' ability to shift profits to low-income countries by taxing foreign "passive" income on an accrual basis. In that sense, even countries with a formal territorial system do not exempt all foreign-source income from domestic tax.

INBOUND INVESTMENT

Countries, including the United States, generally tax the income foreign-based multinationals earn within their borders at the same rate as the income domestic-resident companies earn. Companies, however, have employed various techniques to shift reported profits from high-tax countries in which they invest to low-tax countries with very little real economic activity.

The US subpart F rules, and similar rules in other countries, limit many forms of profit shifting by domestic-resident companies but do not apply to foreign-resident companies. Countries use other rules to limit income shifting. For example, many countries have "thin-capitalization" rules, which limit companies' ability to deduct interest payments to related parties in low-tax countries in order to reduce reported profits from domestic investments.

TCJA enacted a new minimum tax, the Base Erosion Alternative Tax (BEAT) to limit firms' ability to strip profits from the United States. BEAT imposes a 10.5 percent alternative minimum tax on certain payments, including interest payments, to related parties that would otherwise be deductible as business costs.

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Key Elements of the U.S. Tax System

How does the current system of international taxation work?

TAXES AND MULTINATIONAL CORPORATIONS

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Q. How do US corporate income tax rates and revenues compare with other countries'?

A. The US corporate income tax rate is now lower than the top rate in all other leading economies except for the United Kingdom. Corporate income tax revenues in the United States as a share of gross domestic product have been lower than the average in other leading economies, even before the 2017 reduction in the US corporate tax rate.

CORPORATE TAX RATES

The 2017 Tax Cut and Jobs Act (TCJA) reduced the top US corporate tax rate from 35 percent to 21 percent and the average combined federal and state rate from 38.9 percent to 25.9 percent. As a result, the top US corporate tax rate, including the average state corporate rate, is now lower than that of all other leading economies in the G7 except the United Kingdom (with a 19 percent rate). Further, it is slightly below the average rate, weighted by gross domestic product (GDP), for the other Organisation for Economic Co-operation and Development (OECD) countries (figure 1).

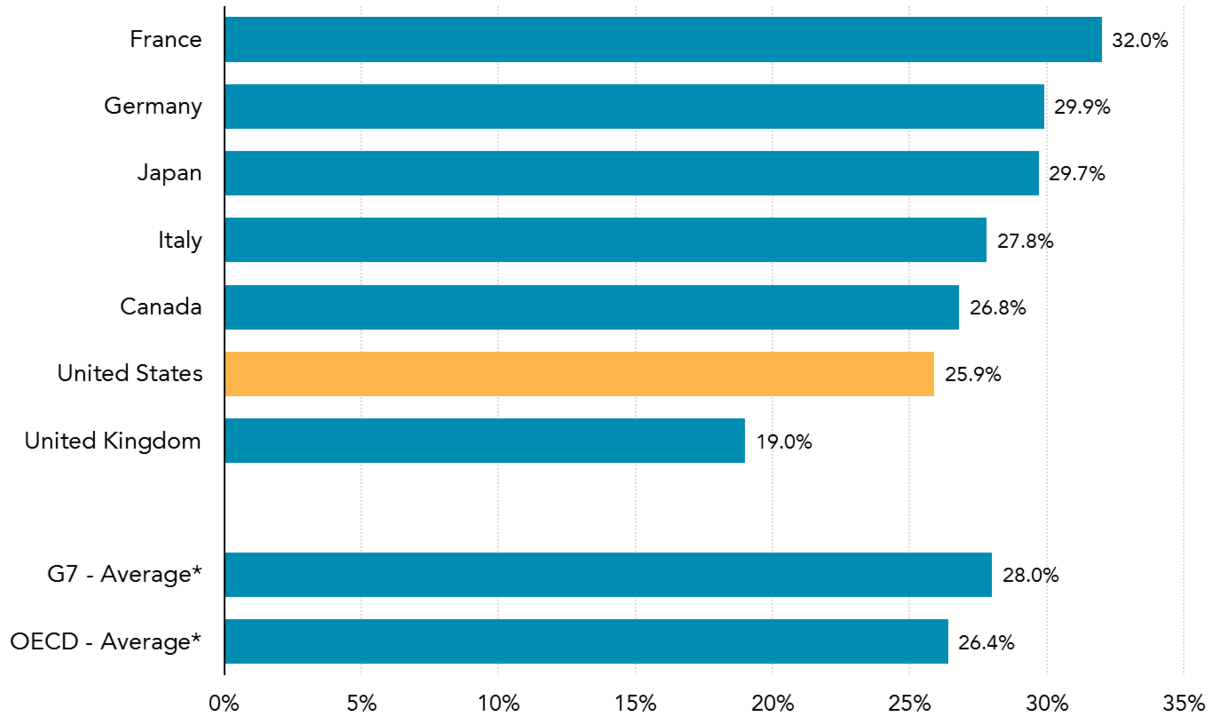
Key Elements of the U.S. Tax System

How do US corporate income tax rates and revenues compare with other countries'?

FIGURE 1

Maximum Corporate Income Tax Rates

Select Organisation for Economic Co-operation and Development (OECD) countries, 2019



Source: OECD. Corporate Tax Statistics, Comparative Tables, Table II.1. Statutory corporate income tax rate: 2019. March 2020.
Notes: Includes tax rates from both federal and sub-national governments. The averages are weighted by GDP for all relevant countries excluding the United States.

CORPORATE TAX REVENUES

The United States raises less revenue from corporate income taxes as a share of GDP than all other countries in the G7 and almost all other countries in the OECD (figure 2).

The Congressional Budget Office projects that federal corporate tax revenues will increase from 1.1 percent of GDP in fiscal year 2019 to about 1.4 percent of GDP in fiscal year 2024 as temporary investment incentives enacted in the TCJA phase out. Corporate tax revenues will then decline slightly to about 1.3 percent of GDP at the end of the 10-year budget period due to the expiration of temporary tax collections from a one-time transition tax on foreign profits accrued prior to enactment of the TCJA. These projections assume that bonus depreciation enacted in the TCJA will phase out beginning in 2023 as currently scheduled and that base-broadening measures and the 2026 increases in tax rates for global intangible low-taxed income and foreign-derived intangible income will also occur as scheduled.

Key Elements of the U.S. Tax System

How do US corporate income tax rates and revenues compare with other countries'?

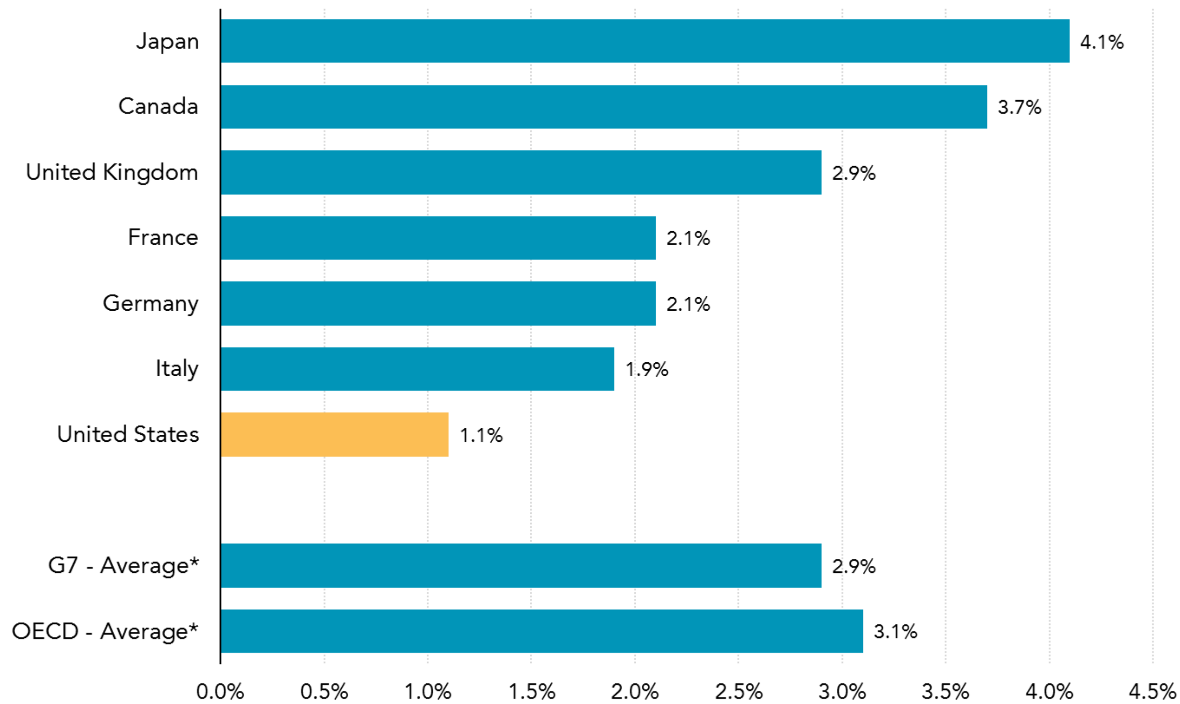
TAXES AND MULTINATIONAL CORPORATIONS

US corporate tax revenues are a smaller share of GDP than in other leading economies because the US has a narrower tax base and an increasing share of business activity originating in businesses not subject to corporate tax (such as partnerships and subchapter S corporations).

FIGURE 2

Corporate Tax Revenues as a Share of GDP

Select Organisation for Economic Co-operation and Development (OECD) countries, 2018



Source: OECD. Revenue Statistics, OECD Data, Tax on corporate profits: 2018. March 2020.
Notes: Includes tax rates from both federal and sub-national governments. The averages are weighted by GDP for all relevant countries excluding the United States.

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How do US corporate income tax rates and revenues compare with other countries'?

Key Elements of the U.S. Tax System

What are the consequences of the new US international tax system?

TAXES AND MULTINATIONAL CORPORATIONS

Q. What are the consequences of the new US international tax system?

A. Despite enactment of the 2017 Tax Cuts and Jobs Act, which reduced these incentives, current rules still encourage US multinational firms to earn and report profits in low-tax foreign countries, enable both US- and foreign-based firms to shift profits earned in the United States to other countries, and encourage companies to incorporate in foreign jurisdictions.

INCENTIVES TO EARN AND REPORT PROFITS IN LOW-TAX COUNTRIES

Multinational corporations typically operate overseas through foreign subsidiaries that are mostly taxed as independent corporate entities. This separate entity system gives multinationals incentives to shift reported profits to their affiliates in low-tax jurisdictions by underpricing sales to them and overpricing purchases from them.

For tax-reporting purposes, most governments require firms to use an "arm's length" standard, setting prices for transactions within the corporate group ("transfer prices") equal to the prices that would prevail if the transactions were between independent entities. Yet ample room remains for firms to manipulate transfer prices, especially for intangible assets such as patents that are unique to the firm and for which there is no easily established market price.

Leading multinationals often shift the ownership of their intangibles, which generate a large share of their worldwide profits, to affiliates in very low tax jurisdictions, such as Ireland and Singapore. Through complex transactions, multinationals can then shift reported profits from these jurisdictions to countries with no corporate income tax, such as Bermuda and the Cayman Islands. Typically, multinationals generate very little real economic activity—as measured by output, employment, sales, or investments in plant and equipment—in tax-free jurisdictions.

Before the 2017 Tax Cuts and Jobs Act (TCJA), US multinationals booked a disproportionate share of their profits in low-tax locations. In 2017, US multinationals reported over 40 percent of their overseas profits in three low-tax countries: the Netherlands, Ireland, and Luxembourg (figure 1). The top 10 foreign locations of their profits, including other low-tax countries such as Bermuda, Switzerland, Singapore, the UK Caribbean Islands, and the United Kingdom, accounted for over four-fifths of their non-US profits.

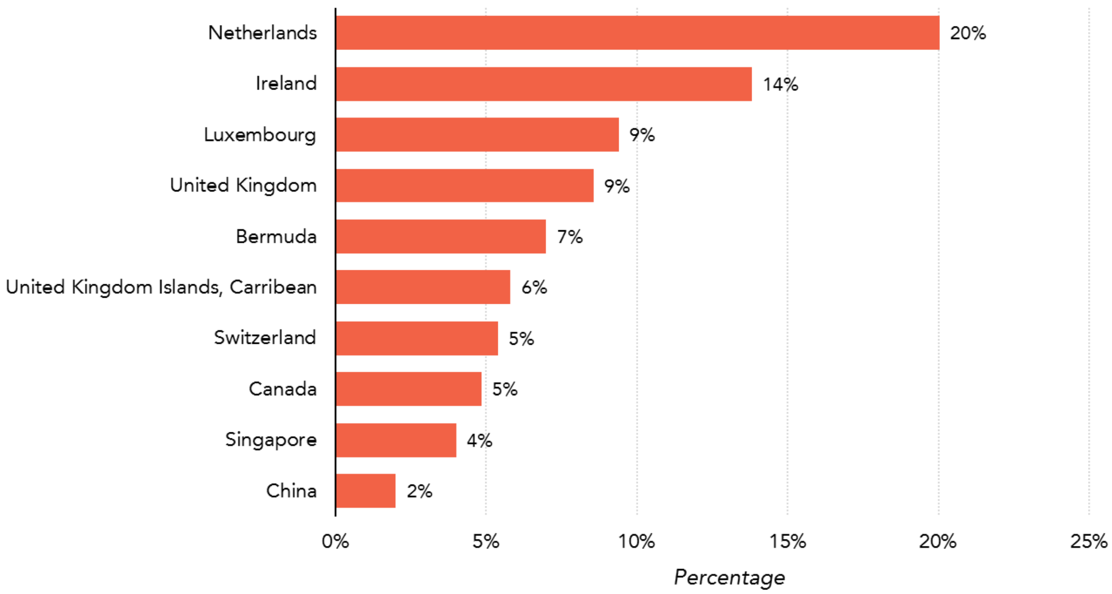
Key Elements of the U.S. Tax System

What are the consequences of the new US international tax system?

FIGURE 1

Top 10 Countries for Non-US Profits of US Multinationals

Net income as a share of total, 2017



Source: Bureau of Economic Analysis. U.S. Direct Investment Abroad (USDIA), Activities of U.S. Multinational Enterprises (MNEs), "Selected Data for Foreign Affiliates in All Countries in Which Investment Was Reported, 2017." February 2020.

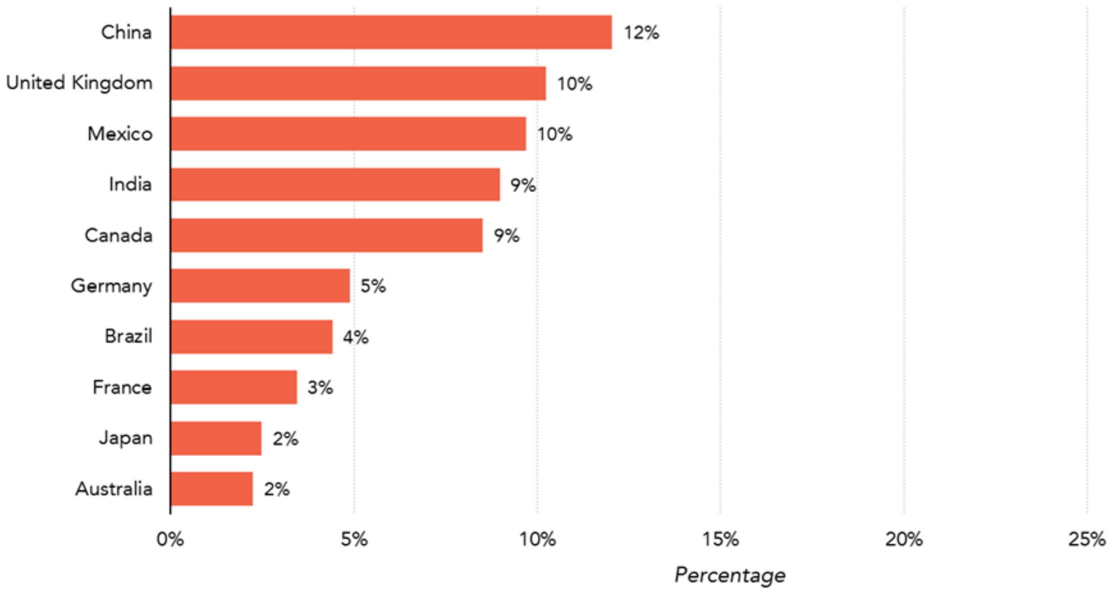
Despite evidence that firms shift the location of real economic activity in response to tax-rate differences among countries, a substantial share of US multinationals' real activity remains in high-tax countries. These are mostly large economies with close ties to the United States (figure 2). Before TCJA, the effective corporate tax rates on new investments in such countries was slightly lower than the US rate.

What are the consequences of the new US international tax system?

FIGURE 2

Top 10 Countries for Non-US Employment of US Multinationals

Employment as a share of total, 2017



Source: Bureau of Economic Analysis. U.S. Direct Investment Abroad (USDIA), Activities of U.S. Multinational Enterprises (MNEs), "Selected Data for Foreign Affiliates in All Countries in Which Investment Was Reported, 2017." February 2020.

The TCJA substantially reduced, but did not eliminate, the incentive for US corporations to shift profits to tax havens. It did this by introducing a new minimum tax on Global Low Tax Intangible Income (GILTI) at 10.5 percent beginning in 2018, increasing to 13.125 percent in 2026. The GILTI rate remains below the 21 percent US corporate rate and the rate in other countries in the G7 (which ranges from 19 percent in the United Kingdom to 34 percent in France). The TCJA also reduced incentives for US companies to hold intangible assets in low-tax foreign countries by providing a special rate (13.125 percent beginning in 2018 and 16.406 percent beginning in 2026) for export income from intangible assets held in the United States (Foreign Derived Intangible Income).

How the TCJA affects the location of reported profits and real activities of US multinationals overseas will not be known for several years. However, we can expect that over time US companies will report lower shares of their profits in low-tax countries with little economic activity.

INCENTIVES TO INCORPORATE OVERSEAS

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production and employment is located, where its sales take place, where its shareholders reside, or even where its top managers live.

For some firms, the tax benefits of foreign residence, combined with the lack of economic substance to the residence definition, have led them to shift the formal incorporation of their parent companies overseas. This type of transaction (“inversion”) can often be accomplished without changing the location of any real business activities.

Over the years, Congress has enacted rules to limit inversions. A company can still “redomicile,” though, by merging with a foreign-based company under certain conditions, including that the original foreign company contribute at least 20 percent of the shares of the new merged company if other conditions are not met. The TCJA added new provisions to penalize new inversions. In exchange for the TCJA eliminating the tax on repatriated dividends, it imposes a 35 percent transition tax on overseas assets that newly inverted firms held before the TCJA. Other US companies with foreign assets pay a comparable transition tax at 15.5 percent for cash and 8 percent for other assets. The TCJA also introduced other penalties on newly inverted firms, including a provision that makes dividends to shareholders taxable as ordinary income instead of at the preferred rates generally applied to qualified dividends and long-term capital gains.

The current US system still provides benefits for some multinational corporations to establish their parent company’s residence outside the United States, although this incentive is smaller at the new reduced corporate tax rate. The United States now imposes GILTI on the intangible profits US-resident corporations earn in low-tax countries, while our major trading partners have so-called territorial systems that exempt active foreign-source profits. In addition, rules for US controlled foreign corporations limit US-based multinationals’ ability to use debt-equity swaps and other earnings-stripping techniques to shift reported income out of the United States. But the United States is unable to apply its controlled foreign corporation rules to foreign-resident multinationals.

The US Department of the Treasury (2016), however, has recently issued new regulations to deter earnings stripping through interest payments to foreign-related parties and the Base Erosion and Anti-abuse Tax (BEAT), enacted as part of TCJA, imposes a minimum tax on a base that disallows deductions for certain payments, including interest, to foreign-related parties. Both Treasury regulations and BEAT aim to limit foreign-resident multinationals’ ability to shift profits out of their US affiliates, although BEAT also affects US-resident companies.

A corporation’s formal residence may be losing significance in an increasingly global economy where capital flows freely and a firm’s research and development, production, and sales are often spread worldwide. The location of a multinational firm’s investment, jobs, research and development, and tax revenue matter more than the site of its parent company. Corporate residence, however, does have some effect on US tax revenues and arguably may matter for research and development and other high-value activities often associated with a company’s headquarters.

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Key Elements of the U.S. Tax System

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Q. How does the tax system affect US competitiveness?

A. The international tax policies that best encourage firms to invest in the United States are not necessarily the policies that best help US multinational companies compete with foreign-based multinationals. Policymakers face a trade-off among goals.

WHAT IS COMPETITIVENESS?

Many—really all—politicians favor "international competitiveness," but the term means different things to different people. To some, it means domestic firms or industries can compete with their foreign counterparts in a global marketplace. For them, this translates into support for "mercantilist" policies that seek to increase exports, reduce imports, or promote more US activity in certain sectors, such as manufacturing.

An alternative form of mercantilism seeks to promote the growth of a country's resident multinational corporations without regard to whether they produce at home or overseas. Concerns about the competitiveness of US multinationals often follow from an assumption that these firms generate spillover benefits for the economy in which they are headquartered. For example, the knowledge created by research and development (R&D) (typically conducted at headquarters) often gets diffused to other domestic producers, boosting productivity more broadly.

By contrast, many economists view free trade and capital movements as mutually beneficial because they raise living standards in all countries. These economists define "competitive" policies as those that increase Americans' standard of living over the long run, without regard to their effects on the balance of trade, the net direction of international capital flows, or success in expanding specific activities, such as manufacturing or R&D.

Global international tax practices seek to promote free capital movements by preventing double taxation of international capital flows. These same practices assign the capital-importing countries rights to tax profits (i.e., the country where production facilities are located).

The capital-exporting country has two ways to avoid double taxation. The first method is simply to exempt taxation of the foreign-source income of its resident companies. The second method is to tax the worldwide income of its resident companies but to allow them to claim credits for foreign income taxes so that their income is taxed at the home-country rate rather than the rate in the country where the income is earned. These two approaches have different implications for a country's attractiveness either as a location for productive investment or as a place for multinational corporations to establish residence.

Although the promise of beneficial spillovers provides an argument for using the tax code to promote R&D and other headquarters activities, direct subsidies such as research credits would be a more cost-effective way to encourage research.

HOW CAN TAX POLICIES ATTRACT INVESTMENT?

Following the 2017 Tax Cuts and Jobs Act (TCJA), the US corporate tax system no longer discourages investment in the United States by US- and foreign-based corporations. Now the top corporate tax rate in the United States (including the effect of state-level taxes) is slightly below the average corporate tax rate of our major trading partners. In addition, capital recovery provisions are more generous in the United States than in many other countries, especially through 2022 when companies can immediately deduct 100 percent of costs of machinery and equipment investment in the United States. (This bonus depreciation provision phases out between 2023 and 2027 at 20 percentage points per year.)

Provisions that make it easier in the United States than in most other countries to establish businesses whose owners benefit from limited liability without being subject to corporate-level taxation also encourage domestic investment. For example, many US corporations lease office buildings from real-estate investment trusts, which pay no corporate income tax, instead of owning them and facing US corporate income tax on the profits they generate.

The US tax system after the TCJA continues to encourage US-based multinationals to invest in low-tax foreign countries instead of at home. US multinationals pay no US tax on foreign-source income up to 10 percent of the value of their tangible foreign capital (the value, net of past depreciation, of machinery, equipment, and structures). But most of the overseas tangible capital of US multinationals is in other major economies with corporate tax rates now similar to or slightly higher than the US corporate tax rate. Exemption of these profits, then, provides little additional benefit. On these investments, there would be no US tax liability—even in a worldwide system—because the credit for foreign income taxes would fully offset US corporate income tax liability.

HOW CAN TAX POLICIES ATTRACT CORPORATE HEADQUARTERS?

The US tax system places US multinationals at a competitive disadvantage with foreign-based multinationals that have income from low-tax countries. US companies now face a 10.5 percent minimum tax on global intangible low-taxed income, defined as global profits above 10 percent of tangible capital. In contrast, most countries in the Organisation for Economic Co-operation and Development and all the other countries in the G7 (Canada, France, Germany, Italy, Japan, and the United Kingdom) have exemption systems that allow their resident multinationals to pay only the foreign tax rate on most of their overseas profits.

How does the tax system affect US competitiveness?

The US and many other countries have controlled foreign corporation (CFC) rules that tax some forms of US multinationals' foreign-source income as it accrues in their foreign subsidiaries at the same rate as domestic-source income. The goal of CFC rules is to prevent schemes that shift the reported profits resident multinationals earn at home to their affiliates in low-tax foreign countries. Because CFC rules, however, apply only to domestic-resident multinationals, they do not prevent similar schemes by foreign-resident multinationals to strip profits from their affiliates in high-tax countries.

Several countries have enacted new taxes on foreign-resident multinationals operating in their countries, including the diverted profits tax in the United Kingdom and similar measures in Italy and India and proposed in France. Many countries also have "thin-capitalization" rules that limit interest deductions to prevent outbound income shifting. The base erosion and anti-abuse tax (BEAT) in the TCJA is a new measure that limits income shifting out of the United States by both US and foreign-resident companies. The BEAT imposes an alternative minimum tax on a tax base that disallows the deduction of certain payments to related parties. Some companies may find ways to avoid the BEAT, and the provision may also do unintended collateral harm to other companies, so its effectiveness is debatable. Nonetheless, BEAT is an effort to improve the competitive position of US-based multinationals by limiting the ability of foreign-based companies to strip profits from their US operations.

WOULD A VALUE-ADDED TAX OR DESTINATION-BASED CASH FLOW TAX INCREASE US COMPETITIVENESS?

Some commentators argue that substituting a value-added tax (VAT) for all or part of the corporate income tax would improve the US trade balance. Unlike the corporate income tax and other levies imposed on income earned in the United States, VATs typically exempt exports and tax imports.

But most economists dispute the claim that a VAT would improve the trade balance, arguing that any benefit to net exports from a VAT would be offset by a resulting appreciation of the US dollar relative to other currencies. In fact, some research suggests that countries that rely heavily on VATs for revenue have lower net exports than those that don't.

Replacing some or all of the corporate income tax with a VAT would, however, affect the trade position of some industries relative to others. Exemptions and lower rates within a VAT affect the relative prices consumers pay for different goods and services but do not distort trade patterns because VAT burdens do not depend on where goods and services are produced. In contrast, preferences within the corporate income tax do affect production location, improving the competitiveness of some US producers while worsening the competitiveness of others, because the tax does affect relative costs of production.

In 2017, House Republicans considered and then abandoned a plan for a destination-based cash flow tax (DBCFT) to replace the corporate income tax. The DBCFT was similar to a VAT in that it would have allowed immediate recovery of capital expenses and would have exempted exports from tax and disallowed a deduction for imports. (It differed from a VAT by allowing companies to deduct wages.) Many commentators expressed concern that the DBCFT would hurt US importers, but prominent economists argued that exchange rates would adjust to neutralize any trade effects of its border-adjustments feature.

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Q. How would formulary apportionment work?

A. Under the current global system, multinational firms determine their profits separately in each tax jurisdiction in which they operate. An alternative system would allocate a firm's worldwide income across countries using a formula based on some combination of its sales, assets, and payroll in each jurisdiction.

HOW FORMULARY APPORTIONMENT WORKS

Under formulary apportionment, a multinational corporation would allocate its profits across countries based on its sales, payroll, and capital base in each jurisdiction. The corporation would pay US corporate tax on the share of its worldwide income allocated to the United States. An alternative formula would base a corporation's US taxes only on the fraction of its worldwide sales destined for domestic consumers, a so-called "destination-based" corporate profits tax.

Many states in the United States use a formulary apportionment system to determine their taxable share of US-source corporate profits. The formulas have been historically based on a weighted average of the shares of sales, payroll, and assets in the state. But some states have shifted to a sales-only apportionment system to remove any incentive to shift employees or facilities to other jurisdictions.

The adoption of formulary apportionment by states was motivated by the widespread perception that states are so highly integrated economically that it is impractical to determine using a separate-entity system how much of a firm's income is earned by an affiliate in one state and how much by an affiliate in another.

ADVANTAGES OF FORMULARY APPORTIONMENT

Formulary apportionment would remove the current artificial incentive for multinationals to shift reported income to low-tax locations. Tax liabilities, instead, would be allocated by a measure (or measures) of their real economic activity in each location. These measures are far more difficult to manipulate for tax purposes than the division of profits among separate entities within a firm.

Formulary apportionment would also reduce the tax system's complexity and the administrative burden it imposes on firms. Firms would no longer have to allocate income or expenses across countries for tax purposes. Because intra-firm transactions would not affect the measure of domestic profits, there would be no need for transfer-pricing rules for intra-firm transactions, which would remove a major source of dispute between corporations and tax authorities.

There would also no longer be a need for controlled foreign corporation rules because all profits assigned to foreign activities would be exempt. For this reason, there would also no longer be a need for foreign tax credits, so firms with deemed profits from intangible assets (GILTI) would have no incentive to earn taxable profits in high-tax foreign countries to increase the availability of offsetting tax credits in low-tax countries.

Absent behavioral responses, the United States and countries with similar tax rates would gain revenue under formulary apportionment: firms' shares of real economic activity in these countries typically exceed the shares of income they now report as originating there instead of in tax havens. The move to formulary apportionment could therefore be made revenue neutral by reducing corporate tax rates. Moreover, formulary apportionment would make a multinational corporation's tax liability independent of both its legal residence and its legal form (for example, branch or subsidiary). Formulary apportionment would thus remove any incentive for corporate inversions in which firms from two countries merge and establish their residence in a low-tax country to reduce their tax liabilities.

PROBLEMS AND DISADVANTAGES OF FORMULARY APPORTIONMENT

Significant issues, however, emerge in designing and implementing a global formulary apportionment system. And such a system would create new incentives for tax avoidance and could increase the incentive to shift real investments to low-tax countries.

Formulary apportionment would require an agreement among the major economies to scrap the current separate-entity system and to agree on how to allocate corporate income among jurisdictions. It would also require agreement on common accounting methods for measuring corporate profits.

A unilateral move by the United States to formulary apportionment would result in double taxation of some multinationals' income and exemption of other income. That's because different countries would use radically different methods of allocating income among jurisdictions.

A formulary apportionment system would introduce new boundary problems between high-tax and low-tax activities. While the current separate-entity system creates incentives to shift reported profits among firms within a multinational corporation, formulary apportionment provides incentives to shift profits between multinationals and separately owned firms. For example, if physical assets help determine the location of a multinationals' profits, a firm might well have an incentive to contract its low-margin manufacturing activities in high-tax jurisdictions to independently owned firms instead of establishing a manufacturing subsidiary within the firm to reduce its share of capital assets allocated to high-tax countries.

How would formulary apportionment work?

Further, formulary apportionment could worsen the incentive to shift real activities to low-tax countries because intangible assets—a large share of value for many leading multinational companies—are part of a firm's total profits but are absent from the allocation formula. Intangible assets magnify the effects on the firm's tax liability of putting more real capital in low-tax countries. They increase the share of both the firm's return to real capital and its return to the intangible profits taxed at lower rates.

Some analysts and commentators favor sales- or destination-based allocation of corporate profits because firms are least likely to reduce sales in a jurisdiction simply to reduce tax liability. A problem with a sales-based allocation, however, is that multinationals can then avoid tax on the profits from their intangible assets by selling their products to independent distributors in low-tax countries, who would then resell them throughout the world. Although rules could be written to prevent such abuses, they would be cumbersome and hard to enforce. Most multinationals sell most of their output primarily to other companies in complex supply chains rather than directly to final consumers.

A modified version of the sales-based allocation approach would combine a separate entity approach with transfer pricing to allocate a company's routine profits among countries with a sales-based formula allocation approach for allocating so-called "residual" profits. This Organisation of Economic Cooperation and Development (OECD) has released a public consultation document describing an approach of this type as Pillar One of a new effort to reform global rules for allocating profits of multinational corporations.

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Q. What are inversions, and how will TCJA affect them?

A. An inversion is a transaction in which a US-based multinational company merges with a smaller foreign company and then establishes its residence in the foreign company's country. As a foreign resident, the company can sometimes significantly reduce its taxes without changing the location of any real business activities.

The current US system treats multinational enterprises whose parent companies are incorporated in the United States (US-resident multinationals) differently from those that are resident elsewhere. The United States imposes a minimum tax on the active profits above a 10 percent rate of return that its multinationals accrue within their foreign affiliates, while our major trading partners have so-called territorial systems that exempt their resident multinationals' active foreign-source income. In addition, US anti-abuse rules limit US-based multinationals' ability to use debt-equity swaps to shift reported income out of the United States, but do not apply the same limits to foreign-resident multinationals. New provisions, however, place limits on these profit-shifting activities by foreign-resident multinationals.

The United States bases its definition of corporate residence on place of incorporation. This definition need not be consistent with where a company's production is located, where its sales take place, where its shareholders reside, or even where its top managers live.

In prior years, the tax benefits of foreign residence, combined with the residence definition's lack of economic substance, led some US-based multinationals to formally incorporate their parent companies overseas. This transaction ("inversion") can often be accomplished without changing the location of any real business activities. Some recent research (Rao 2015), however, finds that inverted companies over time increase their shares of employees and investment overseas compared with companies that did not invert.

In the two decades before enactment of the 2017 Tax Cuts and Jobs Act (TCJA), US multinationals accumulated a large amount of unrepatriated foreign cash, increasing the motivation for inversion transactions (Clausing 2014). The TJCA eliminated taxes on repatriation of foreign-source income, thereby ending the incentive for US companies to retain assets overseas. In lieu of the repatriation tax, the TCJA imposed a minimum tax of 10.5 percent on certain accrued foreign-source income and a one-time transition tax of 15.5 percent for cash assets and 8 percent for non-cash assets accumulated in foreign affiliates before the end of 2017. The transition tax is payable on a backloaded schedule over eight years. These new taxes are payable whether or not a company repatriates its foreign assets, so firms are no longer encouraged to retain assets overseas. In response to the TCJA, US firms reduced their overseas cash holdings, using most of the repatriated funds to pay their shareholders dividends and to repurchase shares.

Over the years, Congress has enacted rules to limit inversions. Simple inversions—a US company establishes a foreign affiliate, which then becomes the parent company—no longer work because the United States would continue to treat the new company as a US resident. A company can still "redomicile," though, by merging with a foreign-based company under certain conditions; these include a requirement that the original foreign company contribute at least 20 percent of the shares of the newly merged company if other conditions are not met.

A recent wave of inversion transactions, like previous waves, generated considerable concern among US policymakers and led to legislative proposals and administrative measures to impose additional limits on merger transactions. The US Department of the Treasury in 2014 issued new regulations to prevent avoidance of the 20 percent threshold on foreign ownership and to make it more difficult for newly merged companies to repatriate earnings accrued before the merger tax-free. In 2016, Treasury issued additional regulations (Shay 2014; US Department of the Treasury 2016) that reclassified certain debt transactions between related parties as equity instead of debt. The regulations deterred foreign-based companies from paying their US affiliates' tax-deductible interest to other affiliates in low-tax countries, a practice known as income stripping.

TCJA included additional measures to deter inversions. The transition tax rate on inverted firms' existing overseas assets was set at the full pre-TCJA rate of 35 percent instead of the reduced rates of 8 and 15.5 percent for other firms' assets. And the dividends shareholders receive from any newly inverted firms are taxable as ordinary income instead of at the reduced rates generally applied to qualified dividends and capital gains.

While Congress and the public have viewed inversions with great concern, changes in existing US corporations' residence are not the only way the share of world output by US-based multinationals can decline over time. Foreign-based multinationals can purchase smaller US companies or divisions of larger ones. New companies can be chartered overseas instead of in the United States. And foreign-based multinationals can expand faster than US-based companies if US tax laws place US multinationals at a disadvantage. In the long run, limits on inversions may be less important in promoting US corporate residence than tax laws in the United States and overseas that create a level playing field between US-resident and foreign-resident companies with operations in both the United States and our major trading partners.

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Q. What is a territorial tax and does the United States have one now?

A. Under a territorial tax, the United States would not tax profits earned overseas by US-resident corporations. The Tax Cuts and Jobs Act effectively exempted some of these profits, but retained taxation on some categories of foreign profits and imposed a new minimum tax on another.

When corporations based in one country earn profits from production in other countries, the countries involved must decide on the appropriate tax base. Such rules should prevent multiple layers of taxation from impeding international trade and investment flows while providing that corporate profits are taxable somewhere.

One option is a territorial tax system that taxes only the portion of a corporation's income originating within the country's borders. This prevents double taxation of cross-border flows because resident corporations' foreign-source income is exempt from tax.

Another option is a worldwide system that taxes all domestic-source income, as well as the foreign-source income of resident corporations. To prevent double taxation, countries with worldwide systems allow their resident corporations to claim tax credits to offset their foreign income taxes. They also typically allow their resident companies to defer tax on active profits earned by foreign affiliates (controlled foreign corporations, or CFCs) until those profits are repatriated to the parent company. This feature of tax systems—known as deferral—substantially reduces effective tax rates on foreign-source income in countries with worldwide systems, making them not that different from territorial systems.

Territorial and worldwide systems would be the same if all countries had the same tax rates. Then, credits under a worldwide system would exactly offset otherwise-payable taxes on foreign-source income. But the systems are different if countries have different corporate tax rates. Territorial systems encourage a country's resident multinational corporations to shift real investment and reported profits to low-tax foreign countries. Worldwide systems (with deferral) reduce this incentive because resident corporations pay the domestic tax rate when they repatriate profits earned in low-tax countries. But worldwide systems place resident corporations at a disadvantage compared with companies based in countries with territorial systems that impose no domestic tax on the profits their resident companies earn in low-tax foreign countries. Most countries have moved closer to territorial systems by eliminating taxation of the repatriated dividends their resident companies receive from their CFCs.

IMPLEMENTING TERRITORIAL TAXATION

Implementing territorial systems requires defining the source of a multinational corporation's profits. This was straightforward when most profits were attributable to physical assets with a fixed location, such plant, equipment, and structures. Today, however, an increasing share of profits comes from returns to intangible assets, such as patents, trademarks, and copyrights. Firms in technology, pharmaceuticals, and other sectors have been able to reduce their tax liability by shifting ownership of and profits from intangible assets to low-tax jurisdictions where little real economic activity occurs. By charging affiliates in high-tax jurisdictions a royalty for these intangible assets, such firms lower their overall tax bills. Also, firms can often allocate corporate debt and overhead costs among jurisdictions in ways that reduce their tax burdens.

Countries have two basic strategies to prevent companies from eroding the domestic corporate tax base by assigning reported profits to low-tax foreign jurisdictions. The first approach is to enact detailed rules that define the source of profits. These include rules to determine the "transfer prices" companies can report on goods traded within a multinational group; rules for allocating interest, overhead, and research costs; and provisions to limit interest deductions on debt between related parties. The recent report on base erosion and profit shifting by the Organisation for Economic Co-operation and Development includes a long list of recommendations for how to curb income shifting.

The second approach applies limited worldwide taxation as a backup to territorial taxation. Most advanced countries have enacted so-called CFC rules that subject some forms of "passive" income (such as interest and dividends) their resident multinationals earn within CFCs to current taxation. The subpart F rules in the US Internal Revenue Code, enacted in 1962, are an example of such a provision. By taxing certain types of easy-to-shift income on a worldwide basis, CFC rules limit the benefit of income shifting. CFC rules, however, only apply to a country's resident multinationals and therefore do not prevent foreign-resident companies from shifting profits earned within a country's borders to low-tax jurisdictions.

THE CURRENT US TAX SYSTEM

The current US system is a hybrid between a territorial and a worldwide system. The Tax Cuts and Jobs Act (TCJA) eliminated taxation of repatriated dividends but expanded taxation of income accrued within CFCs. The current system can be characterized as a territorial system for normal returns from foreign investment, defined in the US tax law as return of up to 10 percent on tangible assets, because these returns face no US corporate income tax. The result is that US companies investing overseas and foreign-resident companies from countries with territorial systems both pay only the local corporate income tax rate in countries where they place physical capital assets. In addition, US companies no longer have an incentive to avoid US taxation by contracting production to locally owned firms, as they would under worldwide taxation.

What is a territorial tax and does the United States have one now?

The new tax law, however, departs from territorial taxation in its treatment of intangible profits, which represent the bulk of profits for some of the largest US multinational corporations. Because TCJA eliminated the tax on repatriated dividends, it increased the rewards for income shifting: profits now not only accrue tax-free overseas, but are also tax-free when brought back to the US parent. To counter this, TCJA included GILTI, the tax on global intangible low-taxed income. This low-rate tax on intangible profits as they accrue reduces the incentive to shift these profits out of the United States.

Finally, the new tax law retains the long-standing rules in subpart F for taxing the passive income US firms accrue within their foreign affiliates. These rules, and similar rules in other countries, have long been viewed as a needed backstop to prevent base erosion in territorial systems.

Bottom line—the US system is a hybrid between a territorial and a worldwide system. It still retains some incentives of a pure territorial system to invest in lower-tax foreign countries instead of at home and to shift reported profits to lower-tax jurisdictions. And it still retains some features of a worldwide system that may place US multinationals at a competitive disadvantage compared with multinationals resident in other jurisdictions. But the hybrid nature of the system makes the problem of income shifting smaller than it would be in a pure territorial system and makes the competitiveness problem smaller than it would be in a pure worldwide system. And the lower 21 percent corporate rate in the new tax law makes both problems smaller than under the previous corporate rate of 35 percent.

Finally, the system continues to be extremely complex. How companies will adjust their behavior in response to revised incentives, how new Treasury regulations will affect these incentives, and how effective the IRS will be in enforcing the new rules remains to be seen.

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Q. What is the TCJA repatriation tax and how does it work?

A. The Tax Cuts and Jobs Act repatriation tax is a one-time tax on past profits of US corporations' foreign subsidiaries.

Before the 2017 Tax Cuts and Jobs Act (TCJA), the United States generally taxed its corporations and residents on their worldwide income. However, a US corporation could defer foreign income by retaining earnings indefinitely through a foreign subsidiary. The US corporation would pay US tax on the foreign earnings only when they were repatriated (by a dividend from the foreign subsidiary, for example). Upon repatriation, the earnings would be subject to US taxation at a rate up to 35 percent, with a credit for foreign taxes paid. The repatriation typically resulted in a net US tax obligation because the US tax rate was usually higher than the foreign tax rate. As of 2015, US corporations accumulated more than $2.6 trillion of earnings in foreign subsidiaries, according to the Joint Committee on Taxation.

Pursuant to the TCJA, the United States now generally exempts the earnings of a US firm from active businesses of foreign subsidiaries, even if the earnings are repatriated (i.e., there now is a 100 percent dividend-received deduction). But, as a transition to the new system and to avoid a potential windfall for corporations that had accumulated unrepatriated earnings abroad, the new law taxes these earnings as if they were repatriated but at preferred lower rates.

There are two tax-preferred rates for the foreign earnings deemed repatriated: foreign earnings held in cash and cash equivalents were taxed at 15.5 percent and those not held in cash or cash equivalents at only 8 percent. The TCJA permits a US corporation to pay any tax on the deemed repatriations in installments over eight years. The tax revenue raised by this transition tax on earnings accumulated abroad was estimated at $340 billion over the 10 years from 2018 to 2027.

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Q. What is the TCJA base erosion and anti-abuse tax and how does it work?

A. The BEAT, a new tax under the Tax Cuts and Jobs Act, limits the ability of multinational corporations to shift profits from the United States by making deductible payments to their affiliates in low-tax countries.

Over the past several decades, US multinational corporations have used a variety of techniques to shift profit from the United States to other countries (and, thereby, have eroded the US tax base). A US-based multinational corporation might, for example, pay an affiliate in a lower-taxed country to use patents or other intellectual property in the United States. This would increase the US corporation's costs, thus reducing their reported profits in the United States and increasing their revenue and their reported profits in the lower-taxed country, potentially lowering the corporation's overall tax bill. Prior US tax laws attempted to limit profit shifting, mainly by regulating what are called transfer prices between companies, but the Internal Revenue Service struggled to enforce these laws effectively.

To limit future profit shifting, the Tax Cuts and Jobs Act (TCJA) added a new tax, the BEAT (base erosion and anti-abuse tax). The BEAT targets large US corporations that make deductible payments, such as interest, royalties, and certain service payments, to related foreign parties. The BEAT is a minimum tax add-on: A US corporation calculates its regular US tax, at a 21 percent rate, and then recalculates its tax at a lower BEAT rate after adding back the deductible payments. If the regular tax is lower than the BEAT, then the corporation must pay the regular tax plus the amount by which the BEAT exceeds the regular tax. The BEAT rate is 5 percent in 2018, 10 percent in 2019 through 2025, and 12.5 percent in 2026 and beyond.

For example, suppose, in 2019, a US corporation has $300 million of gross income but pays deductible royalties to a foreign affiliate of $200 million. The corporation's regular tax liability is $21 million (21 percent of $100 million), but its alternative tax is $30 million (10 percent of $300 million), so the corporation would pay $30 million to the United States (the regular tax of $21 million plus the BEAT of $9 million).

The BEAT applies only to large multinational enterprises, those with gross receipts of more than $500 million (averaged over the prior three years). It also applies only to a corporation that makes more than 3 percent of its total deductible payments to foreign affiliates. However, the BEAT excludes payments that can be treated as cost of goods sold. For example, if a US company properly accounts for interest or royalties as part of the cost of its inventory, the interest or royalties are not added back to the BEAT tax base.

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Q. What is global intangible low-taxed income and how is it taxed under the TCJA?

A. GILTI is the income earned by foreign affiliates of US companies from intangible assets such as patents, trademarks, and copyrights. The Tax Cuts and Jobs Act imposes a new minimum tax on GILTI.

Before the 2017 Tax Cuts and Jobs Act (TCJA), the United States generally taxed its firms and residents on their worldwide income. However, US firms could defer the tax on foreign subsidiaries' active business earnings until those earnings were repatriated to the United States as dividends. After the TCJA, the United States generally exempts earnings from active businesses of US firms' foreign subsidiaries, even if the earnings are repatriated. (The United States still taxes the income from passive investments of foreign subsidiaries.)

But Congress worried that completely exempting US multinationals' foreign earnings might exacerbate the incentive to shift profits to low-tax jurisdictions abroad. So, Congress added a new 10.5 percent minimum tax on global intangible low-taxed income (GILTI) to discourage such profit shifting. GILTI is intended to approximate the income from intangible assets (such as patents, trademarks, and copyrights) held abroad. Congress considered intangible assets highly mobile—and sought to discourage US firms from shifting these assets offshore.

More specifically, a US business must include GILTI in its gross income annually. GILTI is calculated as the total active income earned by a US firm's foreign affiliates that exceeds 10 percent of the firm's depreciable tangible property. A corporation (but not other businesses) can generally deduct 50 percent of the GILTI and claim a foreign tax credit for 80 percent of foreign taxes paid or accrued on GILTI. Thus, if the foreign tax rate is zero, the effective US tax rate on GILTI will be 10.5 percent (half of the regular 21 percent corporate rate because of the 50 percent deduction). If the foreign tax rate is 13.125 percent or higher, there will be no US tax after the 80 percent credit for foreign taxes.

For example, suppose a US corporation is the sole shareholder of a foreign corporation with a manufacturing plant in Ireland, which has a 12.5 percent tax rate. Suppose the plant cost $100 million to construct, and the foreign income is $30 million (after properly allocating expenses). The corporation would calculate GILTI of $20 million (total foreign income minus 10 percent of $100 million of depreciable assets). The US tax on GILTI would be $2.1 million before credits for foreign taxes (half of the $20 million of GILTI times the 21 percent corporate tax rate), and the net US tax after credits would be $0.1 million ($2.1 million−$2 million credit for Irish taxes). In practice, the calculations are much more complicated, as US corporations may have multiple operations abroad—and how to properly allocate expenses among them is unclear.

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Q. What is foreign-derived intangible income and how is it taxed under the TCJA?

A. Foreign derived intangible income is income that comes from exporting products tied to intangible assets, such as patents, trademarks, and copyrights, held in the United States. The Tax Cuts and Jobs Act taxes FDII at a reduced rate.

As part of the 2017 Tax Cuts and Jobs Act, Congress lowered the tax rate for US corporations' foreign-derived intangible income (FDII). Congress effectively reduced the tax rate on foreign-derived sales and service income to 13.125 percent, rather than the regular 21 percent, seeking to encourage US corporations to export more goods and services, and locate more intangible assets in the United States.

The FDII computation is complicated, but it is intended to approximate income from the sale of goods and services abroad attributable to US-based intangible assets such as patents, trademarks, and copyrights. As with the provisions of the new law related to global intangible low-taxed income, Congress approximated the income attributable to a US firm's intangible assets by the income that exceeds a 10 percent deemed return on its depreciable tangible property. The share of the excess income allocated to the sale of goods and services abroad is taxed at a reduced rate.

For example, suppose a US corporation earned $100 million, with tangible assets of $200 million. The firm would allocate the deemed intangible income, $80 million ($100 million of earnings−$20 million deemed return on its tangible assets), between foreign and domestic sales of goods and services. The United States would tax the share of the $80 million allocated to foreign sales at 13.125, rather than the regular 21 percent. In 2026, the rate on FDII will rise from 13.125 to 16.83 percent.

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