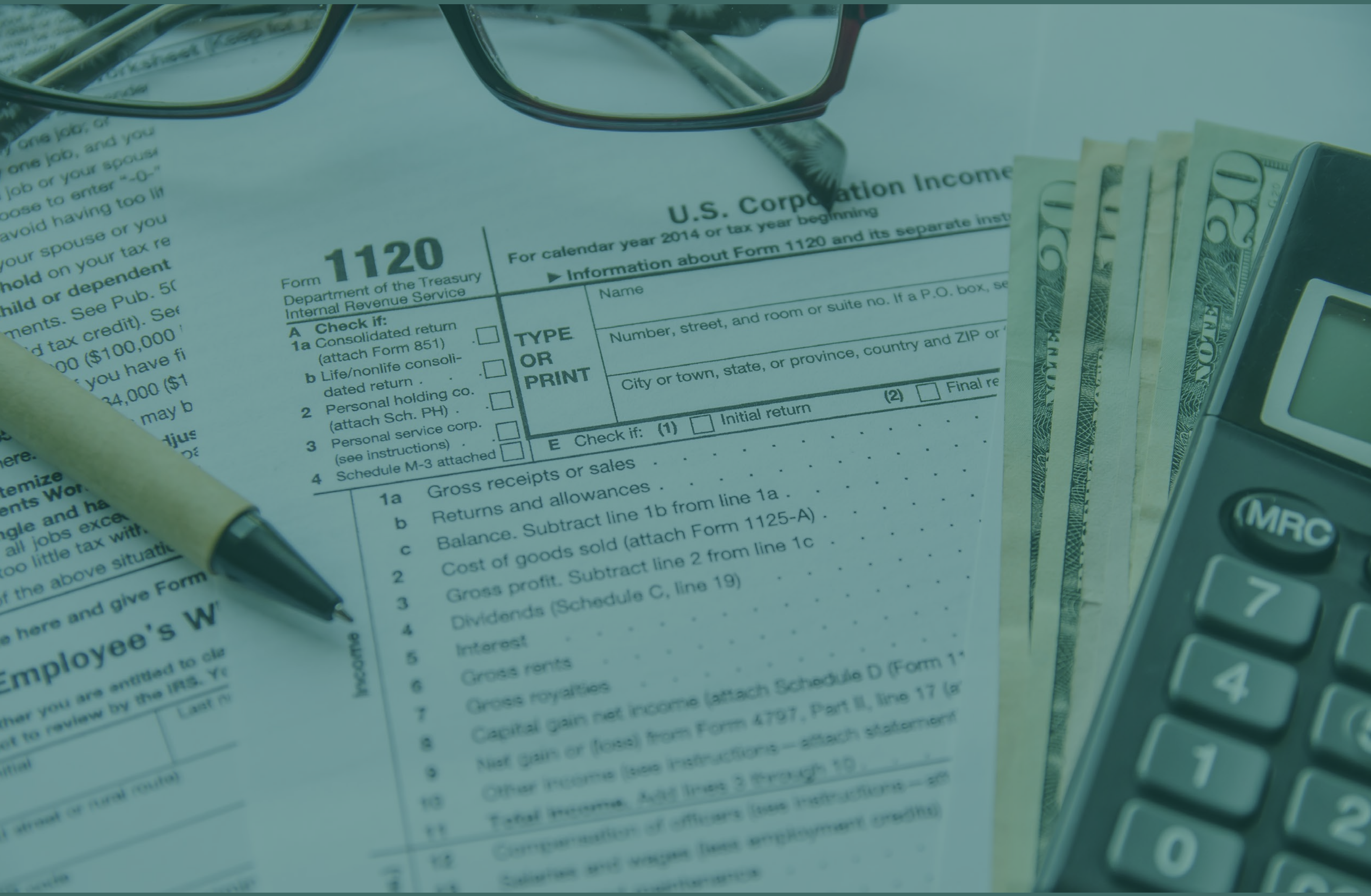
Overhauling International Taxation

A framework to invest in the American people by ensuring multinational corporations pay their fair share



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The 2017 tax law's international provisions are a complex mess that created new incentives to ship jobs overseas. The bill is a massive giveaway to big corporations, was crafted behind closed doors, and rushed through Congress. Republicans took the wrong approach to cross-border taxation, and their policies need an overhaul.[1]

The international tax system should focus on rewarding companies that invest in the U.S. and its workers, stop incentivizing corporations to shift jobs and investment abroad, and ensure that big corporations are paying their fair share. Not only would these reforms make our international tax system better, they can raise revenue necessary to invest in America. 2021 provides an opportunity to make this a reality, and American workers and families can be the beneficiaries.

The framework outlined below presents some ideas on how to reboot the international tax system to achieve these important goals through changes to the 2017 tax law's international provisions. Comments and feedback are requested and can be sent to InternationalTax@finance.senate.gov no later than April 23rd.

GILTI

The global intangible low-taxed income (GILTI) system gave big corporations a huge reduction in the U.S. tax rate on foreign earnings and created incentives to offshore jobs and stash profits in tax havens. This system needs significant reforms to ensure big corporations pay their fair share, while helping to spur investment in the U.S., not in foreign countries.

End the incentive to offshore factories

Republicans gave large, multinational corporations the ability to earn tax-free foreign income by putting tangible assets abroad.[2] The more factories, machinery, and buildings constructed overseas, the more tax-free income the corporations can earn. This incentive to offshore stems from an exemption for “qualified business asset investment” (QBAI)—roughly the value of offshore tangible assets.[3]

This is an irrational incentive to put new investment abroad rather than here, or, even worse, shut down U.S. factories and move them overseas[4]—those factories and jobs could have remained in the U.S. Simply put, this policy should be repealed. There cannot be such an explicit subsidy for American companies to offshore factories and the American jobs that go with them.

Increase the GILTI rate

Republicans set the GILTI rate at just half of the U.S. corporate tax rate, creating a strong preference to earn income overseas.[5] It is necessary to shrink the gap between the tax rate on U.S. earnings and foreign earnings. This would reduce incentives to shift more profit abroad, and help level the playing field between multinational corporations and corporations operating primarily in the U.S.

It is an open question whether the tax rate on GILTI should equal the U.S. corporate tax rate—effectuating a fully ‘worldwide’ international tax system—or still remain at a lower proportion of the U.S. rate—e.g., 75 percent, as proposed by President Biden.[6] The final determination will depend heavily on corresponding decisions regarding the U.S. corporate rate, base stripping protections, and other potential incentives or disincentives for U.S. and foreign investment. Prior Democratic proposals suggested taxing foreign earnings at a rate between 60 and 100 percent of the U.S. corporate rate.[7]

Move GILTI to a country-by-country system

The net amount of GILTI tax owed to the U.S. depends, in part, on the amount of tax paid to foreign countries, through the foreign tax credit system. But it does so on a global basis, combining all foreign income and taxes in one global average calculation. Not only does this system open the door to the abuse of tax havens—it actually encourages it. Under GILTI, the best tax-avoidance planning structures match high-tax income (typically from real business operations in major economies, such as Germany or Japan) with low-tax income (often from intangibles stashed in tax havens).[8] For every dollar of income earned in a country that applies a substantive tax, a corporation will try to shift profits to a tax haven to reduce or eliminate its GILTI taxes.

To reduce the shifting to tax havens, the tax system should look at how much tax is paid in any particular country, rather than opening the door for abuse with global averaging. This is why many have proposed using a "country-by-country" system for applying GILTI.

One country-by-country option is to expand the existing system for foreign tax credits—with the use of foreign tax credit "baskets"—essentially applying the current GILTI rules separately for each country in which a corporation operates. For example, if a corporation operates in nine countries, it would have nine GILTI "country baskets," with no aggregation among them. This system would help reduce profit shifting and the abuse of tax havens.

A second option that achieves the same country-by-country objective, potentially in a much simpler fashion, is to divide global income into two groups—low-tax and high-tax. Rather than applying the foreign tax credit system to every single country separately, GILTI would only be applied to income from low-tax jurisdictions. This would allow a significant amount of global income to be aggregated, but without any of the abuses present in the current GILTI system. Income from high-tax countries would be excluded from GILTI through the use of a mandatory high-tax exclusion—if a corporation paid a foreign country a tax rate that was above the GILTI rate, it would be excluded from GILTI altogether. All the income that remains in the system is, by definition, from countries where the foreign tax rate was below the GILTI rate—in tax parlance, there would be no "excess credits" in the system to cover for low-tax income. These earnings would be aggregated and subject to the current GILTI rules. This achieves the goals of a country-by-country system in a simpler way, making it easier for the IRS to enforce.

Ironically, the Trump Treasury Department already provided all the necessary operational details as part of their regulations creating an elective high-tax exclusion for GILTI.[9] While the regulations were a dubious interpretation of current tax laws, the vast majority of these rules can be co-opted in a mandatory high-tax exclusion, but in a more effective and fair system. Instead of providing a back-end regulatory tax cut (which the Trump regulations did), these rules can instead be flipped on their head to target offshore tax haven abuse by multinational corporations. Few new rules need to be adopted, and businesses would be applying systems (GILTI and the high-tax exclusion) that are already in place. By using two existing regimes, such a system could be quickly implemented to make corporations start paying their fair share right away.

Add an incentive to onshore research and management jobs

A significant part of the GILTI system is the complex rules limiting the use of foreign tax credits. The foreign tax credit rules were created and have evolved over time to police abuse, but the interaction of the GILTI regime with the foreign tax credit limitation can create perverse incentives. A prime example: taxes owed under GILTI increase when a corporation invests in research and development in the U.S. or expands a U.S. headquarters office.[10] These expenses are often related to good-paying U.S. jobs and investments that have positive spillover effects, and we should not retain unnecessary incentives to offshore them.

A simple change will help create more incentives for doing research and locating administration in the U.S.: expenses for research and management that actually occur in the U.S. should be treated as entirely domestic expenses, eliminating foreign tax credit penalties under GILTI and helping retain these activities in the U.S.

FDII

The system for foreign-derived intangible income (FDII) provides a preferential rate for certain income of a U.S. corporation. It is designed to be part of a matching pair with GILTI, and, as a result, exacerbates one of GILTI's worst attributes—the incentive to offshore factories.

To the extent that the tax rate on GILTI remains lower than the U.S. corporate rate, an argument can be made to retain a provision like FDII. There is also a reasonable case that FDII provides little value—but at great revenue cost—in our current system. If FDII retains an offshoring incentive and cannot drive valuable investment in the U.S., then it will never be a sustainable provision and is almost certainly not worth keeping. But, if it could actually drive investment in the U.S. and create innovation, rather than rewarding giant corporations for offshoring jobs and earning massive profits, it may yet have grounds for retention. The following posits a potential design to repair it.

Repeal the incentive to offshore factories

Just like GILTI, the FDII system uses the value of tangible assets like factories and buildings to determine the potential FDII benefit. And, just like GILTI, a company is better off under FDII if it moves its factories or puts new investment abroad.[11] The use of these assets in the calculation—also called QBAI, like under GILTI—is a mistake, and penalizes companies that grow their footprint in the U.S.

And, just as with GILTI, the first step to improve FDII is to repeal the incentive to shift factories abroad, so that companies do not have an incentive in the tax code to move factories and jobs overseas.

Provide the FDII benefit to companies that continually invest in innovation in the U.S.

A new FDII, focused on U.S. innovation, could reward companies that continually invest in ways that help grow our economy and strengthen our workforce, rather than just rewarding companies with huge profits.

To do so, FDII's "deemed intangible income" would be replaced with a new metric—deemed *innovation* income. The new "DII" would be an amount of income equal to a share of expenses for innovation-spurring activities that occur in the U.S., such as research and development and worker training. It would only apply if the expense were for U.S. activities. It would encourage companies to continually innovate, since current year spending would determine the benefit, rather than spending from prior years. And, the more spent on innovation creation, the more income would be treated as DII. Since the "intangible" concept in FDII was a cause of many of the provision's problems, this would be renamed "foreign derived innovation income."

Equalize the FDII and GILTI rates

Even when trying to create a matching pair with GILTI and FDII, the architects of the 2017 tax law could not help but put the thumb on the scale for offshoring income, by making the GILTI rate (10.5 percent) lower than the FDII rate (13.125 percent).[12] If FDII remains, regardless of what the final GILTI and FDII rates are, those rates should be equalized.

BEAT

While the base erosion and anti-abuse tax (BEAT) was nominally created to target base-eroding activities, Republicans inexplicably also cut the value of important tax incentives for U.S. investment in things like renewable energy, low-income housing, and job-creation in low-income neighborhoods. Among other flaws in the BEAT, this only hurts U.S. investment while doing little to prevent erosion of the U.S. tax base. The BEAT should be reformed to capture more revenue from companies eroding the U.S. tax base, and use that revenue to support companies that are actually investing in America.

Provide full value to domestic business tax credits

Tax credits that support investment and opportunity here in the U.S. need to have their full value restored under the BEAT. Congress created these tax credits to drive investment into important sectors and under-served regions, and the BEAT should not undercut them.

A secondary concern is how the BEAT addresses foreign tax credits. That could be addressed based on the availability of additional revenue from the BEAT system.

Increase the BEAT rate on base erosion payments

The BEAT was not just a policy to target base erosion and domestic investment—it was also an offset used to help Republicans slash corporate taxes by more than $1.3 trillion. Since the BEAT only applies to very large corporations, addressing even its most egregious flaws may involve further reducing taxes for the largest multinational corporations. As such, any improvement to the BEAT that loses revenue should be offset through revenues from better aligning the BEAT with its true purpose: penalizing base erosion.

There are multiple ways to adjust the BEAT, but one alternative puts any additional burden squarely where it should be—on companies that are stripping the U.S. tax base. While the current BEAT applies a 10 percent tax rate to both “regular” income and to income tied to “base erosion payments,” the BEAT can be more focused on actual base eroders through the use of a second rate bracket. Regular taxable income would still be subject to a 10 percent rate, while base erosion payments would be subject to a higher rate.

In combination with the restoration of value for domestic business credits, this increased tax on companies that are doing the most to erode the U.S. tax base will be used to support companies that are investing in the U.S.

CONCLUSION

Through these reforms, the 2017 tax law’s international tax provisions can be overhauled. Instead of juicing corporate profits and pushing factories offshore, these proposals put the focus back on American workers and reward businesses investing in the U.S.

Endnotes

1 For more analysis of problems with the 2017 tax law's international provisions, see the Senate Finance Committee Democratic Staff (2018, July 18). "Trump's Tax Law and International Tax: More Complexity, Loopholes and Incentives to Shift Jobs Overseas." https://www.finance.senate.gov/imo/media/doc/Wyden%20Report%20-%20Trumps%20Tax%20Law%20and%20International%20Tax%20071818.pdf.

2 I.R.C. sec. 951A(b)(1)(B), which reduces the GILTI amount by the net deemed tangible income return.

3 I.R.C. sec. 951A(d).

4 For more discussion, see Dharmapala, D. (2018, August). "The Consequences of the TCJA's International Provisions: Lessons from Existing Research." *SSRN*, 17-18. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3212072 ("The GILTI tax instead encourages US firms to acquire tangible assets in foreign countries, regardless of the local tax rate. It is readily apparent from the definition of GILTI…that the acquisition of tangible assets abroad creates a shield against the GILTI tax."); And see Beyer, B., Downes, J., Rapley, E. (2019, May). "The Effect of the Tax Cuts and Jobs Act of 2017 on Multinational Firms' Capital Investment: Internal Capital Market Frictions and Tax Incentives." 1 ("The TCJA also includes several provisions which could result in the unintended consequence of incentivizing multinational firms to invest in foreign assets) and 26("[W]e do find evidence consistent with an increase in foreign investment post-TCJA. We propose that the new provisions introduced by the TCJA provide tax incentives for multinational firms to increase foreign investment. Specifically, the GILTI inclusion (FDII deduction) incentivizing (penalizing) firms to increase foreign (domestic) investment.")

5 See Kysar, R. (2018, October 25). "Critiquing (and Repairing) the New International Tax Regime." The Yale Law Journal Forum, 344 ("Given the wide differential between the domestic rate and the minimum tax rate, there remains substantial motivation to shift profits."). https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3436942.

6 The White House (2021, March 31). "Fact Sheet: The American Jobs Plan". https://www.whitehouse.gov/briefing-room/statements-releases/2021/03/31/fact-sheet-the-american-jobs-plan/.

7 See, e.g., Sen. Wyden and Sen. Coats, The Bipartisan Tax Fairness and Simplification Act of 2011, S. 272 , 112th Cong. (2011) (foreign earnings taxed at 100% of the U.S. rate). https://www.congress.gov/bill/112th-congress/senate-bill/727/text; The 2016 Obama Administration Greenbook, Department of the Treasury (2016, February), "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals"(foreign earnings taxed at approximately 68% of the U.S. rate). https://home.treasury.gov/system/files/131/General-Explanations-FY2017.pdf; Sen. Baucus Staff Discussion Draft: International Business Tax Reform, (2013, Nov. 19) (foreign earnings taxed at 80% under "option Y" and 60% under "option Z"). https://www.finance.senate.gov/chairmans-news/baucus-unveils-proposals-for-international-tax-reform.

8 See comments of Rosenbloom, D (2019, November). "The Future of the New International Tax Regime," Fordham Journal of Corporate & Financial Law, Vol. 24, Num. 2, 292 ("The big thing about GILTI that people have to realize is that GILTI implies a great deal of averaging….This creates a great incentive to send investment outside the United States because averaging always produces an incentive to go outside the United States. If you are low, you have an incentive to average up by going outside the United States; if you are high, you have an incentive to go abroad to bring the average down."). https://ir.lawnet.fordham.edu/cgi/viewcontent.cgi?article=1473&context=jcfl

9 Guidance Under Sections 951A and 954 Regarding Income Subject to a High Rate of Foreign Tax, 85 Fed. Reg. 44,620, July 23, 2020; see also Guidance Under Section 954(b)(4) Regarding Income Subject to a High Rate of Foreign Tax, 85 Fed. Reg. 44,650, July 23, 2020.

10 Versprille, A., Kassam, S., Bulusu, S. (2019, March 20). “Treasury Pressed to Fix Tax Mistake That May Push R&D Offshore”, Bloomberg Law. (“The issue is that the 2017 tax law didn’t account for existing rules requiring companies to attribute certain U.S. business expenses to their taxable foreign income….that means companies could pay more U.S. tax on their foreign income if they increase R&D spending in the U.S.”).

11 Beyer et al, fn 4 (“Thus, to minimize overall taxes, firms can minimize their GILTI inclusion and maximize their FDII deduction by increasing foreign rather than domestic investment in tangible assets.”)

12 Under I.R.C. sec. 250, these effective rates occur through a 50 percent deduction for GILTI, but only a 37.5 percent deduction for FDII.