U.S. INTERNATIONAL TAX POLICY: OVERVIEW AND ANALYSIS

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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on March 25, 2021, titled "How U.S. International Tax Policy Impacts American Workers, Jobs, and Investment." This document,[1] prepared by the staff of the Joint Committee on Taxation, describes legal and economic background on U.S. taxation of cross-border activities.

Part I includes an introduction to the basic principles of international taxation and present law. While providing a general overview, it focuses on selected provisions newly enacted or substantially revised in Public Law 115-97. Subpart A is a general overview, subpart B describes taxation of foreign activities by U.S. taxpayers, and subpart C describes the provisions addressing taxation of U.S. activities of foreign taxpayers.

Part II summarizes international efforts to address tax challenges of the digitalization of the economy and the implications for the United States.

Part III provides an analysis of recent economic literature that addresses cross-border taxation.

Part IV analyzes data based on U.S. corporate tax filings for the first two taxable years to which Public Law 115-97 applied.

This document revises JCX-16-21 released on March 19, 2021. This document provides updated calculations and descriptions for the data included in Section IV. (Background Data). In particular, descriptions and calculations for Tables 1, 2, 3, 5, 10, and 11 have been revised to properly identify data items and correct errant calculations.

[1] This document may be cited as follows: Joint Committee on Taxation, *U.S. International Tax Policy: Overview and Analysis* (JCX-16R-21), April 19, 2021. Unless otherwise stated, section references are to the Internal Revenue Code of 1986 (the "Code"). This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

I. OVERVIEW OF U.S. TAXATION OF CROSS-BORDER ACTIVITY

The following discussion provides an overview of international legal principles and their implementation in the U.S. taxation of income from cross-border business activity. The basic concepts of determining where income may be taxed and how they are reflected in the Code are described, with emphasis on selected changes enacted in Public Law 115-97.[2]

A. General Overview of International Principles of Taxation

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct and persons (whether natural or juridical) with a sufficient nexus to the sovereign nation. The nexus may be based on nationality, *i.e.*, a nexus based on a connection between the relevant person and the sovereign nation, or may be territorial, *i.e.*, a nexus based on a connection between the relevant conduct and the sovereign nation. Nonetheless, most legal systems respect limits on the extent to which their laws may be given extraterritorial effect. The broad acceptance of such norms extends to authority to regulate cross-border trade and economic dealings, including taxation.

1. Origin-based (source and residence) or destination-based principles

The exercise of sovereign jurisdiction to tax is usually based on either the nationality of the person taxed or the jurisdiction in which the taxed conduct occurs. These concepts have been refined and adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to tax. The elements of nexus and the nomenclature of the principles may differ based on whether the tax is a direct tax or an indirect tax.[3] When determining how to allocate the right to tax a particular item of income, most jurisdictions consider principles based on the *origin* of either the income (source) or the person earning the income (residence), rather than *destination* of the goods or services producing income.

Taxes based on where activities occur, or where property is located, are source-based taxes. The United States generally taxes the U.S. trades or businesses of foreign persons and sales or other dispositions of interests in U.S. real property by foreign persons. In addition, the United States generally taxes items of income that are paid by U.S. persons to foreign persons. Most jurisdictions, including the United States, have rules for determining the source of items of income and expense in a broad range of categories, such as compensation for services, dividends, interest, royalties, and gains.

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[2] Pub. L. No. 115-97, December 22, 2017.

[3] A direct tax is imposed directly on a person (known as a capitation tax), property, or income from property, the burden of which the taxpayer bears and generally cannot shift to another. In the United States, Federal direct taxes must be apportioned among the states (U.S. CONST. Art. 1, Sec. 2, cl. 3), unless they are taxes on income within the meaning of the 16th Amendment. In contrast, indirect taxes are taxes on consumption or the production of goods or services, such as the excise taxes in Chapter 32 of the Code, sales or use taxes, or customs duties, the responsibility for which can be shifted from one taxpayer to another. Indirect taxes and non-income direct taxes are outside the scope of this discussion.

Income taxes based on a person's citizenship, nationality, or residence are residence-based taxes. The United States generally imposes residence-based taxation on U.S. persons in the year in which income is earned. For individuals and domestic entities, this results in taxing them on their worldwide income, whether derived in the United States or abroad, with limited opportunity for deferral of taxation of income earned by foreign corporations owned by U.S. shareholders. As explained in Part I.B, below, income from foreign activities conducted through a foreign entity is generally subject to tax in the year earned or not at all under the current system.

Destination-based principles have not been widely adopted for income tax, and until recently, were generally prevalent only for indirect taxes.[4] The United States does not have a general Federal sales or use tax, although such taxes are in force in the majority of the States, including both origin-based taxes and destination-based taxes. Destination as a basis for determining the appropriate jurisdiction to exercise taxing jurisdiction over certain income has been proposed from time to time, most recently in the context of the international project to address new taxing rights for market jurisdictions in response to challenges of digitalization, discussed in Part II below.[5]

2. Resolving overlapping or conflicting jurisdiction to tax

When the same item is subject to income tax under the rules of two or more jurisdictions, double taxation is usually mitigated by bilateral tax treaties or by laws permitting credit for taxes paid to another jurisdiction. The United States is a partner in numerous bilateral treaties that aim to avoid international double taxation and to prevent tax avoidance and evasion. Another related objective of these treaties is the removal of barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. Bilateral agreements are also used to permit limited mutual administrative assistance between jurisdictions.[6]

In addition to entering into bilateral treaties, the United States participates in multilateral organizations to develop common principles to alleviate double taxation, including as a founding member of the Organisation for Economic Cooperation and Development ("OECD"). The

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[4] OECD, *International VAT/GST Guidelines*, OECD Publishing, 2017.

[5] A destination-based, border adjustment tax was proposed in 2005 (President's Advisory Panel on Tax Reform, *Simple, Fair and Pro-Growth: Proposals to fix America's Tax System*, November 2005). Alan Auerbach "A Modern Corporate Tax," Center for American Progress, 2010; House Republic Tax Reform Task Force, "A Better Way: Our Vision for a Confident America," June 24, 2016, available at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf; and Alan Auerbach, Michael P. Devereux, Michael Keen, Paul Oosterhuis, Wolfgang Schohn, and John Vella, "Destination-Based Cash Flow Taxation," *Taxing Profits in a Global Economy*, Oxford University Press, 2020, pp. 267-233.

[6] Although U.S. courts extend comity to foreign judgments in some instances, they are not required to do so, and absent clear intent in legislative language, domestic law is presumed to not have extraterritorial effect. *Morrison v. National Australia Bank Ltd.*, 561 U. S. 247, 255 (2010). At present, the United States has such bilateral agreements permitting tax collection assistance in force with five jurisdictions: Canada; Denmark; France; the Netherlands; and Sweden.

OECD has led such efforts since the latter half of the 20th century, including the promulgation of a model treaty,[7] a precursor of which was first developed by a predecessor organization in 1958, which in turn has antecedents from work by the League of Nations in the 1920s.[8] As a consensus document, the OECD model treaty is intended to aid countries in constructing their own bilateral treaties. The provisions have been revised and updated over time as practice with actual bilateral treaties leads to unexpected results and new issues are raised by parties to the treaties.[9] U.S. bilateral treaties are generally consistent with the OECD model treaty.

3. Principles common to inbound and outbound taxation

The United States imposes source-based taxation on U.S.-source income of nonresident alien individuals and other foreign persons. Under this system, the application of the Code differs depending on whether income arises from outbound investment (*i.e.*, foreign investments by U.S. persons) or inbound investment (*i.e.*, U.S. investment by foreign persons). While the United States taxes inbound and outbound investment differently, certain rules are common to the taxation of both, including residency rules, entity classification rules, source determination rules, and transfer pricing rules.

Residence

The Code defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, trusts and estates.[10] Partnerships and corporations are domestic if organized or created under the laws of the United States, any State, or the District of Columbia, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[11] All other partnerships and corporations (*i.e.*, those organized under the laws of foreign countries) are foreign.[12] Other jurisdictions may use factors such as situs or management and control to determine residence. As a result, legal entities may have more than

[7] OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing, 2014, available at http://dx.doi.org/10.1787//mtc_cond-2014-en. The multinational organization, dedicated to global development, was first established in 1961 by the United States, Canada, and 18 European countries, and has since expanded to 37 members.

[8] See "Report by the Experts on Double Taxation," League of Nations Document E.F.S. 73\F19 (1923), which was a report commissioned by the League at its second assembly; see also Lara Friedlander and Scott Wilkie, "Policy Forum: The History of Tax Treaty Provisions—And Why It Is Important to Know About It," 54 *Canadian Tax Journal* No. 4 (2006).

[9] For example, the OECD initiated a multi-year study on base-erosion and profit shifting in response to concerns of multiple members. For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can also be found on the Joint Committee on Taxation website at www.jct.gov.

[10] Sec. 7701(a)(30).

[11] Sec. 7701(a)(4).

[12] Sec. 7701(a)(5) and (9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

one tax residence, or, in some cases, no residence. In such cases, bilateral treaties may resolve conflicting claims of residence.

Exception for corporate inversions

In certain cases, a foreign corporation that acquires a domestic corporation or partnership may be treated as a domestic corporation for Federal tax purposes.[13] That result generally applies following a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (often referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (the "expanded affiliated group"), does not have substantial business activities in the entity's country of organization, compared to the total worldwide business activities of the expanded affiliated group. If the above requirements are satisfied except that the "stock held by reason of" the acquisition is less than 80 percent, but at least 60 percent of the stock of the foreign corporation, the foreign corporation is not treated as a domestic corporation and is instead considered a surrogate foreign corporation for the acquired domestic company which is an expatriated entity that must recognize certain "inversion gain" post-acquisition restructuring[14] and may be subject to other consequences under the provisions enacted in 2017.[15]

Entity classification

Certain entities other than "*per se* corporations" are eligible to elect their classification for Federal income tax purposes under the "check-the-box" regulations,[16] which affects the determination of the source of the income, availability of tax credits, and other tax attributes. Both foreign and domestic entities may make the election. As a result, an entity formed in the United States and operating in at least one other jurisdiction may be treated as a hybrid entity (*i.e.*, treated as a partnership or disregarded entity for U.S. tax purposes but as a corporation for

[13] Sec. 7874. The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under section 7874 since the section was enacted in 2004, and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions.

[14] An excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985. In addition, dividends from certain surrogate foreign corporations are excluded from qualified dividend income within the meaning of section 1(h)(11)(B) and are ineligible to be taxed as net capital gains. Sec. 1(h)(11)(C)(iii). As a result, individual shareholders in such corporations cannot claim the reduced rate on dividends otherwise available under section 1(h)(11).

[15] See section 59A(d)(4) (providing that payments made to expatriated entities that reduce gross receipts are base erosion payments) and section 965(l) (disallows the partial participation exemption deduction for computing the transition tax and assesses the additional transition tax in the year of inversion if an entity inverts within 10 years of the transition tax enactment).

[16] Treas. Reg. sec. 301.7701-1, *et seq*.

foreign tax purposes) or a reverse hybrid entity (*i.e.*, treated as a corporation for U.S. tax purposes but as a partnership or disregarded entity for foreign tax purposes).

Source of income rules

Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor or recipient and the location of the activities or assets that generate the income. The Code includes extensive rules on determining whether income is considered to be from U.S. sources or from foreign sources.[17] Special rules are provided for certain industries, (*e.g.* transportation, shipping, and certain space and ocean activities) as well as for income partly from within and partly from without the United States.[18]

While many rules for determining source have been unchanged over the years, changes made in 2017 addressed the sale of inventory by eliminating the title passage rule. Gains, profits, and income from the sale or exchange of inventory property that is either (1) produced (in whole or in part) inside the United States and then sold or exchanged outside the United States or (2) produced (in whole or part) outside the United States and then sold or exchanged inside the United States is allocated and apportioned solely on the basis of the location of production activity.[19] For example, income derived from the sale of inventory produced entirely in the United States is wholly from U.S. sources, even if title passage occurs elsewhere. Likewise, income derived from the sale of inventory produced entirely in another country is wholly from foreign sources, even if title passage occurs in the United States. If inventory is produced only partly in the United States, the income derived from its sale is sourced partly in the United States regardless of where title to the property passes**.**

Intercompany transfers

Transfer pricing

A basic U.S. tax principle applicable in dividing profits from a transaction between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in a similar transaction with unrelated parties bargaining at arm's length (the "arm's-length standard"). The transfer pricing rules of section 482 authorize the Secretary to allocate income, deductions, credits, or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance. Treasury regulations under that section generally adopt the arm's-length standard as the method for determining whether a particular allocation is appropriate. Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is

[17] Sections 861-through 865, generally.

[18] Sec. 863.

[19] Sec. 863(b).

determined in part by the same transfer pricing rules of section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

For income from intangible property, section 482 provides, "in the case of any transfer (or license) of intangible property (within the meaning of section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[20]

Gain recognition on outbound transfers of intangible property

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize gain from the transfer as though the transferor had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity, or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer.[21] The appropriate amounts of those imputed payments are determined using transfer-pricing principles.

[20] H.R. Rep. No. 99-426, p. 423.

[21] Sec. 367(d).

B. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons

In general, income earned directly by a U.S. person from the conduct of a foreign trade or business is taxed currently,[22] while income earned indirectly through certain related foreign entities (*i.e.*, controlled foreign corporations ("CFCs"))[23] is taxed in the year earned or not at all. Indirect earnings of CFCs are generally taxable in one of two ways. First, the earnings may constitute income to U.S. shareholders under the traditional anti-deferral regime of subpart F, which applies to certain passive income and certain other related-party income that is readily movable from one jurisdiction to another.[24] Second, the earnings may be subject to section 951A, which applies to some foreign-source income of a CFC that is not subpart F income (referred to as global intangible low-taxed income ("GILTI")). Subpart F income is taxed at full rates with related foreign taxes generally eligible for the foreign tax credit; GILTI is taxed at preferential rates with additional limitations on the use of related foreign taxes. Both subpart F income and GILTI are included by the U.S. shareholder without regard to whether the earnings are distributed by the CFC.

Foreign earnings not subject to tax as subpart F income or GILTI generally are exempt from U.S. tax. To exempt those earnings, dividends received by corporate U.S. shareholders from specified 10-percent owned foreign corporations (including CFCs) generally are eligible for a 100-percent dividends-received deduction ("DRD").[25]

In addition to the taxation of GILTI at preferential rates, U.S. corporations generally are taxed at preferential rates on their foreign-derived intangible income ("FDII").[26]

1. Subpart F income

Under subpart F, U.S. shareholders of a CFC must include in income their *pro rata* shares of subpart F income, without regard to whether the income is distributed to the shareholders.[27] In effect, U.S. shareholders of a CFC are treated as having received a current distribution of the

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[22] Such income is called foreign branch income.

[23] A CFC generally is defined as any foreign corporation in which U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only "U.S. shareholders," that is, U.S. persons that own at least 10 percent of the stock (measured by vote or value). Secs. 951(b), 957, and 958. Special rules apply with respect to U.S. persons that are shareholders (regardless of their percentage ownership) in any foreign corporation that is not a CFC but is a passive foreign investment company ("PFIC"). See secs. 1291 through 1298. The PFIC rules generally seek to prevent the deferral of passive income through the use of foreign corporations.

[24] Subpart F comprises sections 951 through 965.

[25] Sec. 245A. The DRD is not limited to dividends from CFCs, but rather may be available with respect to any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a U.S. shareholder with respect to such foreign corporation.

[26] Sec. 250(a)(1)(A).

[27] Sec. 951(a).

CFC's subpart F income. With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one jurisdiction to another. Subpart F income consists of foreign base company income,[28] insurance income,[29] and certain income relating to international boycotts and other violations of public policy.[30]

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[31]

Insurance income subject to current inclusion under subpart F includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization.[32]

Investments in U.S. property

U.S. shareholders also must include their *pro rata* shares of a CFC's untaxed earnings invested in certain items of U.S. property.[33] For this purpose, U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[34] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[35]

Exceptions

Subpart F income does not include certain dividends, interest, rents, and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[36] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor.

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[28] Secs. 952(a)(2) and 954.

[29] Secs. 952(a)(1) and 953.

[30] Sec. 952(a)(3)-(5).

[31] Sec. 954.

[32] Sec. 953(a) and (e).

[33] Secs. 951(a)(1)(B) and 956.

[34] Sec. 956(c)(1).

[35] Sec. 956(c)(2).

[36] Sec. 954(c)(3).

A second exception (the "high-tax exception") is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate in effect at the time the income was earned (*e.g.*, for income earned by a CFC in tax year 2020, more than 90 percent of 21 percent, or 18.9 percent).[37]

A third exception excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC to the extent attributable or properly allocable to income of the payor that is not subpart F income.[38]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[39] With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business, and other requirements must be met.

For a securities dealer, foreign personal holding company income excludes any interest or dividend (or certain equivalent amounts) from any transaction entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475.[40]

Exclusion of previously taxed earnings and profits

A U.S. shareholder may exclude from its income actual distributions of earnings and profits from a CFC that were previously included in income by the U.S. shareholder under subpart F.[41] Any income inclusion resulting from an investment in U.S. property also may be excluded when such earnings and profits are ultimately distributed.[42]

Basis adjustments

A U.S. shareholder of a CFC generally increases the basis in its CFC stock by the amount of subpart F income inclusions and generally reduces the basis in its CFC stock by the amount of any distributions that are excluded from its income as previously taxed earnings and profits.[43]

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[37] Sec. 954(b)(4). This exception applies to an item of income that would otherwise be included in foreign base company income or insurance income within the meaning of sections 954(a) and 953, respectively.

[38] Sec. 954(c)(6). CFC look-through applies to taxable years of foreign corporations beginning before January 1, 2026, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[39] Sec. 954(h).

[40] Sec. 954(c)(2)(C).

[41] Sec. 959(a)(1).

[42] Secs. 959(a)(2) and 956.

[43] Sec. 961.

2. GILTI

A U.S. shareholder of a CFC also must include in gross income its GILTI. GILTI is the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return equals the excess of 10 percent of the aggregate of its *pro rata* share of the qualified business asset investment ("QBAI") of each CFC over certain interest expense.[44]

The formula for GILTI is:

$$GILTI = Net\ CFC\ Tested\ Income - [(10\% \times QBAI) - Interest\ Expense]$$

Although a GILTI inclusion is generally treated as a subpart F inclusion, GILTI is not subpart F income. GILTI is computed at the U.S.-shareholder level rather than the CFC level, with a U.S. shareholder allowed to offset tested income of its CFCs with tested loss of other CFCs in computing net CFC tested income. When computing tax liability associated with GILTI, U.S. shareholders may not take into account certain tax attributes of CFCs with tested loss, such as foreign tax credits and QBAI. In addition, the foreign tax credit limitation is applied separately with respect to GILTI, and no carryovers and carrybacks of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Net CFC tested income

Net CFC tested income means the excess of the aggregate of the shareholder's *pro rata* share of the tested income of each CFC over the aggregate of its *pro rata* share of the tested loss of each CFC.[45]

The tested income of a CFC is the excess of the gross income of the CFC determined without regard to certain amounts that are exceptions to tested income (referred to in this document as "gross tested income") over deductions (including taxes) properly allocable to such gross tested income. The exceptions to tested income are: (1) any effectively connected income described in section 952(b); (2) any gross income taken into account in determining the CFC's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4); (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in section 907(c)(1)).

The tested loss of a CFC means the excess of deductions (including taxes) properly allocable to the CFC's gross tested income over the amount of such gross tested income.

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[44] The interest expense that reduces a U.S. shareholder's net deemed tangible income return is that which is taken into account in determining its net CFC tested income for the taxable year to the extent that the interest income attributable to such interest expense is not taken into account in determining the shareholder's net CFC tested income.

[45] Sec. 951A(c)(1). *Pro rata* shares are determined under subpart F principles (*i.e.*, the rules of section 951(a)(2) and the regulations thereunder).

Qualified business asset investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of the CFC's adjusted bases in specified tangible property that is both used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.[46]

Specified tangible property means any property used in the production of tested income.[47]

Treatment as subpart F income

GILTI inclusions generally are treated in the same manner as amounts included as subpart F income.[48]

Preferential rate on GILTI

The preferential rate on GILTI is achieved by allowing corporations a deduction equal to 50 percent[49] of their GILTI (including the corresponding section 78 gross-up amount).[50]

3. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed a credit for foreign income taxes they pay. In addition, a domestic corporation is allowed a credit for foreign income taxes paid by a CFC with respect to income included by the corporation as subpart F income and GILTI; such taxes are deemed to have been paid by the domestic corporation for purposes of calculating the foreign tax credit.[51]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. The limit is intended to ensure that the credit mitigates double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[52] The limit is

[46] Sec. 951A(d)(1).

[47] Sec. 951A(d)(2). Specified tangible property does not include property used in the production of tested loss; thus, a CFC with a tested loss in a taxable year does not have QBAI for such taxable year.

[48] Sec. 951A(f)(1).

[49] For taxable years beginning after December 31, 2025, the deduction for GILTI is reduced to 37.5 percent. Sec. 250(a)(3)(B). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on GILTI is 10.5 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on GILTI rises to 13.125 percent.

[50] Sec. 250(a)(1)(B). Under section 78, a taxpayer claiming the foreign tax credit with respect to foreign-source income generally must include in income the amount of the related foreign taxes paid.

[51] Secs. 901 and 960; see also secs. 1291(g) and 1293(f) (providing, in the PFIC context, coordination with foreign tax credit rules).

[52] Secs. 901 and 904.

computed by multiplying a taxpayer's total pre-credit U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may (in certain cases) carry back the excess foreign taxes to the previous year or carry forward to one of the succeeding 10 years.[53] No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Deemed-paid taxes

For any subpart F income included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to the aggregate foreign income taxes paid or accrued with respect to such income by the CFC.

For any GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to 80 percent of the corporation's inclusion percentage multiplied by the aggregate foreign income taxes paid or accrued with respect to tested income (but not tested loss) by each CFC with respect to which the domestic corporation is a U.S. shareholder.[54]

Allocation and apportionment of expenses

To determine its foreign tax credit limitation, a taxpayer must first determine its taxable income from foreign sources by allocating and apportioning deductions between U.S.-source gross income and foreign-source gross income in each limitation category. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[55] However, subject to certain exceptions, deductions for interest expense, stewardship expenses, and research and experimental expenses are apportioned based on certain ratios.[56] For example, interest expense is apportioned based on the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets.[57]

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[53] Sec. 904(c).

[54] Sec. 960(d)(1). The inclusion percentage means, with respect to any domestic corporation, the ratio of such corporation's GILTI divided by the aggregate amount of its pro rata share of the tested income (but not tested loss) of each CFC with respect to which it is a U.S. shareholder. Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

[55] Treas. Reg. sec. 1.861-8(b) and (c) and Temp. Treas. Reg. sec. 1.861-8T(c).

[56] Treas. Reg. sec. 1.861-8 through Temp. Treas. Reg. sec. 1.861-14T and Treas. Reg. sec. 1.861-17 set forth detailed rules relating to the allocation and apportionment of expenses.

[57] Sec. 864(e)(2).

Limitation categories ("baskets")

The foreign tax credit limitation is applied separately to GILTI, foreign branch income,[58] passive category income, and general category income.[59] For this purpose, GILTI and foreign branch income include only income that is not passive category income. Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income.[60] All other income is in the general category. Passive income is treated as general category income if earned by a qualifying financial services entity or if highly taxed (*i.e.*, if the foreign tax rate is determined to exceed the highest tax rate specified in section 1 or 11, as applicable).[61] Dividends (and subpart F inclusions), interest, rents, and royalties received by a U.S. shareholder from a CFC are assigned to the passive category to the extent the payments or inclusions are allocable to passive category income of the CFC.[62] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[63]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[64] Foreign losses from one category first offset foreign-source income from other categories. Any remaining overall foreign loss offsets U.S.-source income. The same principle applies to losses from U.S. sources. In subsequent years, any losses deducted against another category or source of income are recaptured. That is, an equal amount of income from the same category or source that generated a loss in a prior year is recharacterized as income from the other category or source against which the loss was deducted. Foreign-source income in a particular category may be fully recharacterized as income in another category, whereas only up to 50 percent of income from one source in any subsequent year may be recharacterized as income from the other source.

A taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus

[58] Foreign branch income is defined for this purpose as "the business profits of [the U.S. taxpayer] which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries." Sec. 904(d)(2)(J).

[59] Sec. 904(d); Treas. Reg. sec. 1.904-4(a). The foreign tax credit limitation is also applied separately to certain additional separate categories. See Treas. Reg. sec. 1.904-4(m).

[60] Sec. 904(d)(2)(A)(i) and (B).

[61] Sec. 904(d)(2)(B).

[62] Sec. 904(d)(3).

[63] Sec. 904(d)(4).

[64] Sec. 904(f) and (g).

no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[65]

4. Dividends-received deduction

As discussed above, income earned indirectly through CFCs is taxed either in the year earned (as subpart F income or GILTI) or not at all. Distributions of previously taxed earnings and profits do not constitute dividends.[66]

A domestic U.S. shareholder generally is allowed a 100-percent DRD for the foreign-source portion of dividends received from a specified 10-percent owned foreign corporation,[67] provided that certain holding period requirements are satisfied.[68] A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder.[69]

The term "dividend received" is intended to be interpreted broadly, consistent with the meaning of the phrases "amount received as dividends" and "dividends received" under sections 243 and 245, respectively. The DRD is not available for any hybrid dividend.[70]

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD.[71] Further, no foreign tax credit or deduction is allowed

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[65] Sec. 909.

[66] Sec. 959(d).

[67] Sec. 245A(a). The foreign-source portion of any dividend equals the amount of the dividend multiplied by the percentage of undistributed earnings that are attributable neither to ECI nor to certain dividends received from domestic corporations. Sec. 245A(c).

[68] A domestic corporation is not permitted a DRD in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10-percent owned foreign corporation at all times during the period. Sec. 246(c)(5).

[69] Sec. 245A(b); see also sec. 951(b) (providing that a domestic corporation is a U.S. shareholder of a foreign corporation if it owns, within the meaning of section 958(a), or is considered as owning by applying the rules of section 958(b), 10 percent or more of the vote or value of the foreign corporation).

[70] A hybrid dividend is an amount received from a CFC for which section 245A(a) would allow a DRD and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States. Sec. 245A(e)(4).

[71] Sec. 245A(d). For purposes of computing the foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must determine its foreign-source taxable income (and entire taxable income) by disregarding: (1) any dividend for which the DRD is taken and (2) any deductions properly allocable or apportioned to (A) income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such foreign corporation, or (B) the stock to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a). Sec. 904(b)(4).

for any taxes paid or accrued with respect to the U.S.-source portion of any dividend received by a domestic corporation from a qualified 10-percent owned foreign corporation.[72]

5. FDII

Domestic corporations generally are taxed at preferential rates on their foreign-derived intangible income ("FDII").[73] The preferential rate is achieved by allowing corporations a deduction equal to 37.5 percent of their FDII.[74] FDII is calculated by multiplying a corporation's "deemed intangible income" by the percentage of its "deduction eligible income" that is derived from serving foreign markets (*i.e.*, "foreign-derived deduction eligible income").[75] A corporation's deemed intangible income equals the excess, if any, of its deduction eligible income over a 10-percent return on its qualified business asset investment ("QBAI").[76] The formula for FDII can be expressed as the following:

$$FDII = [Deduction\ Eligible\ Income - (10\% \times QBAI)] \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

For purposes of computing FDII, a domestic corporation's QBAI is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property[77] used in its trade or business and of a type with respect to which a deduction is allowable under section 167.[78] The adjusted basis in any property generally must be determined using the alternative depreciation system under section 168(g) as in effect on December 22, 2017.

Deduction eligible income and foreign-derived deduction eligible income

Deduction eligible income means, with respect to any domestic corporation, the excess (if any) of the gross income of the corporation determined without regard to certain amounts that

[72] Sec. 245(a)(8).

[73] Sec. 250(a)(1)(A).

[74] For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent. Sec. 250(a)(3)(A). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on FDII is 13.125 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on FDII is 16.406 percent.

[75] Sec. 250(b)(1).

[76] Sec. 250(b)(2). If the quantity in this formula is negative, deemed intangible income is zero.

[77] Specified tangible property means any tangible property used in the production of deduction eligible income. For this reason, the adjusted basis of tangible depreciable property held by a foreign branch generally is excluded from QBAI because foreign branch income is excluded from gross deduction eligible income.

[78] The definition of QBAI for purposes of computing FDII relies on the definition of QBAI for purposes of computing GILTI under section 951A(d), determined by substituting "deduction eligible income" for "tested income" in section 951A(d)(2) and without regard to whether the corporation is a controlled foreign corporation. Sec. 250(b)(2)(B).

are excluded from deduction eligible income (referred to in this document as "gross deduction eligible income") over deductions (including taxes) properly allocable to such gross income.[79]

Foreign-derived deduction eligible income means, with respect to a taxpayer for its taxable year, any deduction eligible income of the taxpayer that is derived in connection with (1) property that is sold[80] by the taxpayer to any person who is not a U.S. person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use[81] or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.[82]

Foreign use means any use, consumption, or disposition that is not within the United States.[83] Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or to certain related parties.[84]

Special rules apply with respect to property or services provided to domestic intermediaries[85] and with respect to certain related party transactions.[86]

Taxable income limitation

If the sum of a domestic corporation's FDII and GILTI (including GILTI-attributable section 78 gross-up amounts) exceeds its taxable income determined without regard to this provision, then the amount of FDII and GILTI (including GILTI-attributable section 78 gross-up) for which a deduction is allowed is reduced (but not below zero) by an amount determined by such excess.

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[79] Sec. 250(b)(3)(A). The amounts excluded from deduction eligible income are: (1) subpart F income; (2) GILTI; (3) financial services income; (4) any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; (5) any domestic oil and gas extraction income of the corporation; and (6) any foreign branch income.

[80] For purposes of determining FDII, the terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Sec. 250(b)(5)(E).

[81] If property is sold by a taxpayer to a person who is not a U.S. person and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.

[82] Sec. 250(b)(4).

[83] Sec. 250(b)(5)(A).

[84] Sec. 250(b)(5)(B) and (C).

[85] Sec. 250(b)(5)(B).

[86] Sec. 250(b)(5)(C).

C. U.S. Tax Rules Applicable to Foreign Persons

Nonresident aliens and foreign corporations generally are subject to U.S. tax only on their U.S.-source income. There are two broad types of U.S.-source income of foreign taxpayers: (1) income that is "fixed or determinable annual or periodical gains, profits, and income" ("FDAP income") and (2) income that is "effectively connected with the conduct of a trade or business within the United States" ("ECI"). FDAP income, although nominally subject to a statutory 30-percent gross-basis tax withheld at its source, in many cases is subject to a reduced rate of, or entirely exempt from, U.S. tax under the Code or a bilateral income tax treaty. ECI generally is subject to the same U.S. tax rules and rates that apply to business income earned by U.S. persons.

Finally, certain U.S. corporations with foreign affiliates are subject to a base erosion and anti-abuse tax ("BEAT") that is in the nature of a minimum tax and payable in addition to all other tax liabilities.[87]

1. Gross-basis taxation of U.S.-source income

FDAP income received by foreign persons from U.S. sources is subject to a 30-percent gross-basis tax (*i.e.*, a tax on gross income without reduction for related expenses), which is collected by withholding at the source of the payment. FDAP income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments.[88] The items enumerated in defining FDAP income are illustrative, and the words "annual or periodical" are "merely generally descriptive" of the payments within the purview of the statute.[89] The categories of income subject to the 30-percent tax and the categories for which withholding is required generally are coextensive.[90]

Exclusions from FDAP income

FDAP income encompasses a broad range of gross income but has important exceptions. Capital gains of nonresident aliens generally are foreign source; however, capital gains of nonresident aliens present in the United States for 183 days or more[91] during the year are income from U.S. sources subject to gross-basis taxation.[92] In addition, U.S-source gains from the sale

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[87] Sec. 59A.

[88] Secs. 871(a) and 881. FDAP income that is ECI is taxed as ECI.

[89] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

[90] See secs. 1441 and 1442.

[91] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under section 7701(b).

[92] Sec. 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as ECI under the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). See sec. 897(a)(1).

or exchange of intangibles are subject to tax and withholding if they are contingent on the productivity, use, or disposition of the property sold.[93]

Interest on bank deposits may qualify for exemption from treatment as FDAP income on two grounds. First, interest on deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, is U.S.-source income but is exempt from the 30-percent tax when paid to a foreign person.[94] Second, interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not U.S.-source income and, thus, is not subject to U.S. tax.[95] Interest and original issue discount on certain short-term obligations also is exempt from U.S. tax when paid to a foreign person.[96] In addition, there generally is no information reporting required with respect to payments of such exempt amounts.[97]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[98] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[99] certain contingent interest,[100] interest received by a CFC from a related person,[101] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[102]

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[93] Secs. 871(a)(1)(D) and 881(a)(4).

[94] Secs. 871(i)(2)(A) and 881(d); Treas. Reg. sec. 1.1441-1(b)(4)(ii).

[95] Sec. 861(a)(1); Treas. Reg. sec. 1.1441-1(b)(4)(iii).

[96] Secs. 871(g)(1)(B) and 881(a)(3); Treas. Reg. sec. 1.1441-1(b)(4)(iv).

[97] Treas. Reg. sec. 1.1461-1(c)(2)(ii)(A) and (B). A bank must report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treas. Reg. secs. 1.6049-4(b)(5) and -8. The IRS publishes lists of the countries whose residents are subject to the reporting requirements, and those countries with respect to which the reported information is automatically exchanged. See Rev. Proc. 2018-36.

[98] Sec. 871(h)(2).

[99] Sec. 871(h)(3).

[100] Sec. 871(h)(4).

[101] Sec. 881(c)(3)(C).

[102] Sec. 881(c)(3)(A).

Withholding of 30-percent gross-basis tax

The 30-percent tax on FDAP income is generally collected by means of withholding.[103] Withholding on FDAP payments to foreign payees is required unless the withholding agent (*i.e.*, the person making the payment to the foreign person) can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[104]

Often, the income subject to withholding is the only income of the foreign person subject to any U.S. tax. As long as the foreign person has no ECI and the withholding is sufficient to satisfy the tax liability with respect to FDAP income, the foreign person generally is not required to file a U.S. Federal income tax return. Accordingly, the withholding of the 30-percent gross-basis tax generally represents the collection of the foreign person's final U.S. tax liability.

To the extent that a withholding agent withholds an amount, the withheld tax is credited to the foreign recipient of the income.[105] If the agent withholds more than is required, and that results in an overpayment of tax, the foreign recipient may file a claim for refund.

2. Net-basis taxation of U.S.-source income

ECI generally is subject to tax on a net basis under the same U.S. tax rules and rates that apply to business income earned by U.S. persons.[106]

U.S. trade or business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in a U.S. trade or business if the partnership, estate, or trust is so engaged.[107]

Whether a foreign person is engaged in a U.S. trade or business is a factual question that has generated much case law. Basic issues include whether the activity rises to the level of a trade or business, whether a trade or business has sufficient connections to the United States, and whether the relationship between the foreign person and persons performing activities in the United States for the foreign person is sufficient to attribute those activities to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services

[103] Secs. 1441 and 1442.

[104] A withholding agent includes any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treas. Reg. sec. 1.1441-7(a).

[105] Sec. 1462.

[106] Secs. 871(b) and 882.

[107] Sec. 875.

within the United States.[108] Detailed rules govern whether trading in stock or securities, or in commodities, constitutes the conduct of a U.S. trade or business.[109] A foreign person who trades in stock or securities, or in commodities, in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities, or commodities, for the person's own account also generally is not considered to be engaged in a U.S. trade or business so long as the foreign person is not a dealer in stock or securities, or in commodities.

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively connected income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on ECI. Specific statutory rules govern whether income is ECI.[110]

In general, for a foreign person engaged in the conduct of a U.S. trade or business, all income, gain, or loss from sources within the United States is treated as ECI.[111]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross-basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the U.S. trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[112] Under the asset use and business activities tests, due regard is given to whether such asset or such income, gain, deduction, or loss was accounted for through the trade or business.

A foreign person that is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[113] A foreign tax credit may be allowed

[108] Sec. 864(b).

[109] Sec. 864(b)(2) and Treas. Reg. sec. 1.864-2(c) and (d).

[110] Sec. 864(c).

[111] Sec. 864(c)(3).

[112] Sec. 864(c)(2).

[113] A foreign person's income from foreign sources generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income

with respect to foreign income tax imposed on such income.[114] Foreign-source income not included in one of those categories generally is exempt from U.S. tax.

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which the agent regularly fills orders on behalf of the foreign person.[115] If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.[116]

Certain sales and other dispositions

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[117] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the income or gain is ECI if the income or gain would have been ECI in the prior year.[118] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the income or gain attributable to the disposition of the property is ECI if the income or gain would have been ECI had the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business.[119]

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is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, goodwill, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange. Foreign-source dividends, interest, and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income. Sec. 864(c)(4)(B) and (D)(i).

[114] See sec. 906.

[115] Sec. 864(c)(5)(A).

[116] Sec. 864(c)(5)(B).

[117] Sec. 864(c)(1)(B).

[118] Sec. 864(c)(6).

[119] Sec. 864(c)(7).

Allowance of deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. Regulations address the allocation and apportionment of deductions between ECI and other income. Certain deductions may be allocated and apportioned on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. Specific rules provide for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. In general, interest is allocated and apportioned based on assets rather than income.

3. BEAT

The base erosion and anti-abuse tax (the "BEAT") is an additional tax imposed on certain multinational corporations with respect to payments to foreign affiliates.[120]

The BEAT applies only to corporate taxpayers with average gross receipts in excess of $500 million and is determined, in part, by the extent to which a taxpayer has made payments to foreign related parties.[121] The BEAT generally does not apply to taxpayers for which reductions to taxable income ("base erosion tax benefits") arising from payments to foreign related parties ("base erosion payments") are less than three percent of total deductions (*i.e.*, a "base erosion percentage" of less than three percent).

For a taxpayer subject to the BEAT (an "applicable taxpayer"), the additional tax (the "base erosion minimum tax amount" or "BEAT liability") for the year generally equals the excess, if any, of 10 percent of its modified taxable income over an amount equal to its regular tax liability reduced (but not below zero) by the sum of a certain tax credits.[122]

Base erosion tax benefits and base erosion payments

A base erosion tax benefit generally reflects the reduction in taxable income arising from the associated base erosion payment.

A base erosion payment generally is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable.[123] A base erosion payment includes any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition by the taxpayer from the related party of

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[120] Sec. 59A.

[121] For this purpose, a related party is, with respect to the taxpayer, any 25-percent owner of the taxpayer; any person who is related (within the meaning of sections 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer; and any other person who is related (within the meaning of section 482) to the taxpayer. Sec. 59A(g). The 25-percent ownership threshold is determined by vote or value.

[122] Sec. 59A(b).

[123] Sec. 59A(d)(1).

property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).[124]

Base erosion payments generally do not include any amount that constitutes a reduction in gross receipts, including payments for cost of goods sold. Certain other payments are excluded from the definition of base erosion payment, including certain payments for services[125] and any qualified derivative payments.[126]

Calculation of BEAT liability

BEAT liability generally equals the excess, if any, of 10 percent of the taxpayer's modified taxable income over the amount of regular tax liability[127] reduced (but not below zero) by the sum of certain tax credits. The amount of regular tax liability is reduced (and the base erosion minimum tax amount increased) by all income tax credits except for the research credit[128] and a certain portion of applicable section 38 credits.[129] Modified taxable income is the taxpayer's regular taxable income increased by any base erosion tax benefit with respect to any base erosion payment and an adjustment for the taxpayer's NOL deduction, if any.[130]

Special rules for taxable years beginning after December 31, 2025

For taxable years beginning after December 31, 2025, the 10-percent rate on modified taxable income is increased to 12.5 percent and regular tax liability is reduced (and the base erosion minimum tax amount is therefore increased) by the sum of all the taxpayer's income tax credits for the taxable year.[131]

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[124] Sec. 59A(d)(2). A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign related party for any reinsurance payments that are taken into account under sections 803(a)(1)(B) or 832(b)(4)(A). Sec. 59A(d)(3).

[125] Sec. 59A(d)(5).

[126] Sec. 59A(h).

[127] As defined in section 26(b).

[128] Sec. 41(a).

[129] Sec. 59A(b)(4). Applicable section 38 credits are credits allowed under section 38 for the taxable year that are properly allocable to the low-income housing credit (sec. 42(a)), the renewable energy production credit (sec. 45(a)), and the energy investment credit (sec. 48). In general, no more than 80 percent of the amount of applicable section 38 credits for a taxable year can be used to reduce an applicable taxpayer's base erosion minimum tax liability and in no case can applicable section 38 credits reduce the taxpayer's base erosion minimum tax liability by more than 80 percent. Sec. 59A(b)(1)(B)(i)(II).

[130] An applicable taxpayer's modified taxable income is its taxable income for the taxable year increased by (1) any base erosion tax benefit with respect to any base erosion payment and (2) the base erosion percentage of any NOL deduction allowed under section 172 for such taxable year. Sec. 59A(c)(1).

[131] Sec. 59A(b)(2).

Special rules for banks and securities dealers

An applicable taxpayer that is a member of an affiliated group that includes a bank (as defined in section 581) or securities dealer registered under section 15(a) of the Securities Exchange Act of 1934 is subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate.[132] In addition, for purposes of determining whether they are subject to the BEAT, banks and securities dealers are subject to a base erosion percentage threshold of two percent (rather than three percent).[133]

4. Special rules

FIRPTA

A foreign person's gain or loss from the disposition of a U.S. real property interest ("USRPI") is treated as ECI.[134] Thus, a foreign person subject to tax on such a disposition is required to file a U.S. tax return. In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI is generally required to withhold U.S. tax from the payment.[135] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's overall tax liability for the taxable year.

Branch profits taxes

A domestic corporation is subject to U.S. income tax on its net income. The earnings of the domestic corporation may be subject to a second tax, this time at the shareholder level, when dividends are paid. When the shareholders are foreign, the second-level tax may be collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to withholding tax. To approximate those second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign shareholders, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted (to the head office) out of, or amounts of interest that

[132] Sec. 59A(b)(3).

[133] Sec. 59A(e)(1)(C).

[134] Sec. 897(a).

[135] Sec. 1445 and regulations thereunder.

are deducted by, the U.S. branch of the foreign corporation.[136] Those branch taxes may be reduced or eliminated under an applicable income tax treaty.[137]

Limitation on business interest

The amount of business interest (*i.e.*, any interest paid or accrued on indebtedness properly allocable to a trade or business) allowed as a deduction for any taxable year generally is limited to the sum of business interest income of the taxpayer for the taxable year[138] and 30 percent of the adjusted taxable income of the taxpayer for the taxable year.[139] The rule operates to allow business interest up to the amount of business interest income. The deduction for any remaining business interest generally is limited to 30 percent of adjusted taxable income. The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding year and may be carried forward indefinitely.[140]

The limitation on business interest generally applies to any taxpayer for any taxable year, subject to certain exceptions.[141] The limitation is applied at the taxpayer level, but special rules

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[136] Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's "dividend equivalent amount." Sec. 884(a). The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI. Sec. 884(b).

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore generally is subject to 30-percent withholding tax if paid to a foreign person. Sec. 884(f)(1)(A). Certain "excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, also may be subject to 30-percent withholding tax. Sec. 884(f)(1)(B). For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

[137] See Treas. Reg. secs. 1.884-1(g) and -4(b)(8).

[138] Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest income does not include investment income within the meaning of section 163(d). Sec. 163(j)(6).

[139] Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) the amount of any deduction allowed under section 199A. Sec. 163(j)(8). Additionally, for taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to any deduction allowable for depreciation, amortization, or depletion (including any deduction allowable for any amount treated as depreciation, amortization, or depletion). For taxable years beginning after December 31, 2021, adjusted taxable income is computed with regard to deductions allowable for depreciation, amortization, or depletion.

[140] Sec. 163(j)(2).

[141] The limitation does not apply to any taxpayer (other than a tax shelter prohibited from using the cash method under section 448(a)(3)) that meets the $25 million gross receipts test of section 448(c), (*i.e.*, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million). Sec. 163(j)(3). In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership. Aggregation rules apply to determine the amount of a taxpayer's gross receipts under the $25 million gross receipts test.

apply with respect to passthrough entities.[142] In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.

Sales of partnership interests

Gain or loss from the sale or exchange of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.[143] Any gain or loss from such hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

The transferee of a partnership interest must withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.[144] If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.[145]

Hybrid arrangements

Hybrid arrangements exploit differences in the tax treatment of a transaction or entity under the laws of two or more tax jurisdictions to achieve tax benefits, including double nontaxation and deferral. Special rules seek to combat the use of such arrangements. These rules include denying deductions relating to certain interest and royalty payments.[146] Specifically, no deduction is allowed for any "disqualified related party amount"[147] that is paid

[142] See sec. 163(j)(4).

[143] Sec. 864(c)(8)(B).

[144] Sec. 1446(f)(1).

[145] Sec. 1446(f)(4).

[146] Sec. 267A; see also sec. 245A(e) (addressing hybrid dividends).

[147] A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or in which such related party is subject to tax or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. Sec. 267A(b)(1). A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under subpart F. In general, a related party is any person that controls, or is controlled by, the taxpayer, with control being direct or indirect ownership of more than 50 percent of the vote, value, or beneficial interests of the relevant person. Sec. 267A(b)(2).

or accrued pursuant to a hybrid transaction[148] or that is paid or accrued by, or to, a hybrid entity.[149]

[148] A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or in which the recipient is subject to tax. Sec. 267A(c).

[149] A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or in which the entity is subject to tax but not so treated for Federal income tax purposes. Sec. 267A(d).

II. TAX CHALLENGES ARISING FROM DIGITALIZATION AND OECD RESPONSE

In recent years, the OECD has conducted a project to address the tax issues presented by the increasing prominence of digital business models. The project seeks (1) to revise the principles governing profit allocation among related parties and the amount and kind of contact between a company and a country (*i.e.*, nexus) that is deemed sufficient to justify that country's taxation of that company ("Pillar One") and (2) to establish a set of rules to enforce a minimum global level of income taxation, addressing structures used by certain multinational enterprises that allow for the shifting of profits into jurisdictions with low or zero tax rates ("Pillar Two"). The following discussion describes the current status of the OECD project addressing tax challenges presented by digitalization, including a summary of the background of the project and an overview of policy choices made thus far with respect to the OECD project.

A. Background

On October 12, 2020, the OECD released two reports,[150] the Pillar One Blueprint and the Pillar Two Blueprint. These reports are the most recent iteration of work undertaken by the OECD at the direction of the G-20 to address the challenges that digitalization poses to the current international tax principles as a part of the OECD Base Erosion and Profit Shifting ("BEPS") Project begun in 2013. Pillar One addresses how to determine whether a multinational business has adequate nexus with a jurisdiction to warrant allocating taxing rights to that jurisdiction, while Pillar Two seeks consensus for a minimum global level of income taxation. In a report submitted to the G-20 Ministers in February 2021, the OECD summarized its progress and committed to deliver for approval a consensus-based solution to the remaining policy issues by the July 2021 Finance Ministers meeting.[151] In that report, the OECD estimated that the implementation of both pillars could increase annual global corporate tax revenue by about $50 to $80 billion per year.

A Task Force on the Digital Economy ("TFDE") was established in late 2013 as a subsidiary body of the OECD Committee on Fiscal Affairs. In directing the OECD to pursue the economic challenges arising from global digitalization, the G-20 explicitly directed that non-OECD or non-G-20 members be included to ensure global consensus. The resulting body, the

[150] *Tax Challenges Arising from Digitalisation --Report on the Pillar One Blueprint*, ("Pillar One Blueprint"), available at http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm and *Tax Challenges Arising from Digitalisation --Report on the Pillar Two Blueprint*, ("Pillar Two Blueprint), available at http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm. These blueprints and the extensive written commentary received in response formed the basis for discussion during virtual meetings held January 14-15, 2021.

[151] OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, pp. 10-13, February 2021, OECD, Paris, www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-february-2021.pdf.

Inclusive Framework, formed in 2015, now has over 135 members. Since then, multiple reports have been issued, and the deadline for completing work has been extended multiple times.[152]

Throughout the project, the United States has generally argued that the digital industry should not be ring-fenced (*i.e.*, the resolution should not define a specific subset of companies that are to be treated differently from all others), noting both the continuing trend toward digitalization of all industries, making such ring-fencing difficult, as well as the likelihood that any such ring-fencing would disproportionately affect U.S. companies.

Contemporaneously, several jurisdictions (including the European Union, France, the United Kingdom, Spain, and Italy, as well as others) moved forward with unilateral measures to impose digital services taxes. While enforcement of some of these taxes has been delayed, the threat of their imposition and proliferation has contributed to the urgency of the project to reach global consensus.

[152] OECD, *Action Plan on Base Erosion and Profit Shifting*, July 19, 2013, available at http://www.oecd.org/tax/action-plan-ob-base-erosion-and-profit-shifting-9789264202719-en htm; OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, October 5, 2015, available at https://www.oecd.org/tax/beps/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en htm; OECD, *Tax Challenges Arising from Digitalization - Interim Report 2018*, March 16, 2018, available at http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf; OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy - Policy Note*, January 23, 2019, available at http://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf; OECD, *Addressing the Tax Challenges of the Digitalisation of the Economy - Policy Note*, February 13 - March 6, 2019, available at https://www.oecd.org/tax/beps/public-consultation-document-addressing-the-tax-challenges-of-the-digitalisation-of-the-economy.pdf; OECD, *Secretariat Proposal for a "Unified Approach" Under Pillar One - Public Consultation Document*, October 9, available at https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf; OECD, *Secretariat Proposal for a "Unified Approach" Under Pillar One - Public Consultation Document*, October 9, available at https://www.oecd.org/tax/beps/public-consultation-document-secretariat-proposal-unified-approach-pillar-one.pdf.

B. Pillar One

Pillar One has three basic components that may apply to any multinational enterprise ("MNE") within the scope of the proposal and which meets the revenue threshold. Those three components are as follows: The residual profit that may be allocated to market jurisdictions ("Amount A"); a fixed return calculated for routine marketing and distribution activities that take place within market jurisdictions ("Amount B"); and dispute prevention and resolution measures intended to ensure tax certainty.

1. Scope

First, specific industries (including many extractive industries, shipping, airlines, financial services, and construction) are excluded, no matter their size. Next, Pillar One describes the industries within scope as one of two types, automated digital services ("ADS") and consumer-facing businesses ("CFB"), with different standards applicable to the two categories. Whether an MNE falls within one of those categories depends on a series of factors (the "activities test"), the scope of which is extensive and includes both positive and negative factors for deeming an entity to be either ADS or CFB. To determine whether a particular business or service falls within one of those categories one looks to a series of factors on both a positive list and a negative list to determine its inclusion. The OECD notes that there is no political agreement on the use of these two categories, though the technical rules are well-developed.[153]

In addition to being within scope, an MNE must meet an annual revenue threshold of €750 million (approximately $850 million), which is the same as that used for country-by-country reporting. The threshold will likely be based on global revenues using consolidated financials of an MNE group. The proposal specifically anticipates permitting the most widely used record conventions such as the generally accepted accounting principles ("GAAP") and the international financial reporting standards ("IFRS"). In addition, whether a particular business line or segment should be treated on a standalone basis for determining whether it is within scope remains under consideration.

2. Nexus

For an MNE within the scope, whether a particular jurisdiction may tax any of its profits depends on whether the MNE has nexus with the jurisdiction despite the lack of a traditional physical presence. This determination depends on the MNE's activities in that jurisdiction. Pillar One broadens the activities that establish nexus, thereby making more MNEs subject to tax in certain jurisdictions. The intent is, in part, to identify the market where the end user of its goods or services is located and to allow the market country to tax the activity.

Pillar One would establish revenue sourcing rules that vary with the type of good or service. The possibility of applying a *de minimis* aggregate foreign-source income test to eliminate certain small entities or activities from the scope is under consideration.

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[153] Pillar One Blueprint, pp. 13 and 20.

3. Allocation of the new taxing right

Once the jurisdictions in which an in-scope MNE group has nexus have been identified, the extent to which the residual profits are to be allocated is determined by a formula. The ratio of profit before tax is used to assess the profitability of the enterprise and a stipulated reallocation percentage is then applied. The level of the stipulated reallocation percentages has not yet been determined.

Amount A represents the deemed residual profits to be allocated under the new taxing right under Pillar One. For an MNE that has already allocated adequate returns for routine in-country distribution and marketing to a market jurisdiction (*i.e.*, Amount B) and that has no other activity in the country, Pillar One requires no reallocation. The scope of Amount B remains to be determined, but the fixed rate of return on distribution and marketing is expected to be stipulated.

4. Tax certainty

Tax certainty with respect to Pillar One is intended to be based both on dispute prevention through use of specified percentages and formulas to compute Amount A as well as robust dispute resolution techniques to be mandated. Among the resolution techniques under consideration are mandatory arbitration requirements similar to those included in several of the most recent bilateral U.S. tax treaties.[154] The scope of any mandatory arbitration remains in dispute, but is expected to be limited to Amount A.

5. Policy concerns

At the public consultation in January 2021, there was strong support for reaching a consensus-based solution, as well as support for the revenue thresholds as proposed to the extent they were specified. However, there was uncertainty expressed concerning the policy objectives in certain of the aspects as well as numerous calls for clarity and greater simplification. There were concerns that the complexity would make avoiding double taxation difficult.

Among the public comments received were several proposals for approaching Pillar One in a more formulaic manner. For example, Johnson & Johnson proposed use of a broad inclusive definition of routine low-value activities relating to the local market that would exclude only those activities driving residual profits. In that way, the new proposed "Amount Z" would be a fixed return determined or calculated using specified percentages by either the OECD or a by a

[154] Protocols amending bilateral treaties with Spain, Japan and Switzerland were ratified and entered into force in late 2019. In each, new provisions requiring arbitration in certain disputes between competent authorities are mandatory. Text of these treaties can be found at the tax treaty table on the IRS website, available at https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.

designated agency in a simple and replicable process, removing subjective disputes over comparability.[155]

As a counterpoint to the concerns that the process has become too complex to be administrable, civil society representatives commenting at the public consultation were critical of the high threshold for inclusion and the carveout of several industries, arguing that the high threshold will result in a limited number of companies within scope and, thus, in limited additional revenue for the intended beneficiaries of the proposal (*i.e.*, market jurisdictions).

Finally, the business community broadly supported mandatory and binding dispute resolution while several NGOs and representative from certain governments and smaller economies expressed concern about the expense and complexity of mandatory arbitration. Instead, they urged a greater focus on dispute prevention and exploration of alternatives to mandatory arbitration. Both business and NGOs expressed interest in pilot projects to test the administrability of the proposals.

[155] All public comments for the January 2021 consultation may be found on the OECD website, available at http://www.oecd.org/tax/beps/public-comments-received-on-the-reports-on-pillar-one-and-pillar-two-blueprints.htm.

C. Pillar Two

Pillar Two is intended to ensure that profits of MNEs, wherever earned, are subject to tax at a minimum rate, under a new set of rules to be adopted by compliant jurisdictions. Every MNE within scope must calculate an effective tax rate based on its consolidated financial statements.

1. The Pillar Two rules

If the effective tax rate of an MNE is below the agreed-upon international level of tax, the MNE will be taxed in its home jurisdiction under an income inclusion rule ("IIR"). To enforce the IIR, source countries may apply the undertaxed payment rule ("UTPR") when a payment by a company in their country is paid to a company not subject to an IIR. In addition, a subject to tax rule ("STTR") may apply in cases in which a payment from a source country would be eligible for reduced rates of tax under a bilateral treaty but would not be subject to the minimum level of tax in that country.

The same revenue threshold used for Pillar One is used for Pillar Two. However, the proposal provides that revenue threshold is measured without regard to a fixed return on substantive activities, somewhat analogous to the routine return on QBAI that is exempt from GILTI. In addition, certain entities are excluded, including sovereign wealth funds, government bodies, pension funds, and other non-profits.

The Blueprint acknowledges the need to evaluate whether GILTI may be accepted as a regime in compliance with Pillar Two. Although the GILTI inclusion may be deemed to be compliant with the IIR, whether the limitation on foreign tax credits and global blending, as well as its carveouts and treatment of tested losses, will be found to be compliant is uncertain. In addition, after noting the important role of the UTPR as a backstop to the IIR, the Inclusive Framework urged the United States to agree that the BEAT not apply to payments made to entities that are subject to tax in jurisdictions that are compliant with Pillar Two.[156]

Some global blending is permitted in determining the effective tax rate. However, the STTR is applied to specific payments addressed in an applicable bilateral treaty. Whether the rule applies will depend on the rate in the source country, not the company's effective tax rate.

The Pillar Two Blueprint also includes a variety of options for simplification and coordination of the IIR and STTR and dispute prevention. These options include issuance of tax administrative guidance, use of a safe-harbor effective tax rate based on country-by-country reporting, *de minimis* profits exclusions, and use of a single effective tax rate calculation for multiple years.

2. Policy concerns

Business commentary strongly supported accepting the GILTI regime as an acceptable IIR for purposes of Pillar Two. Other commentators expressed reservations about the scope of

[156] Pillar Two Blueprint, p. 20.

such compliance. Commentary about the extent to which the BEAT could similarly be deemed to comply with the UTPR rule was also offered, with some arguing that the BEAT could be compliant, while others arguing that the BEAT should exclude amounts included as GILTI. Again, the treatment of foreign tax credits in computing the BEAT was noted in arguing that the U.S. regimes may not be compliant with the goal of avoiding double taxation.

The complexity and the interaction with other rules, including potential interaction with Pillar One, again prompted extensive calls for simplification from the business community, including requests that any options for simplification be at the election of the taxpayer. In contrast, NGOs and academics emphasized that a desire for simplification must be balanced with need to ensure the effectiveness of the measures. Toward that end, several called for the measures to be phased in slowly, with reduced revenue thresholds over time.

III. ECONOMIC ANALYSIS

A. Introduction

1. Global economic environment

Global economic development and changes in how U.S. MNEs conduct their business operations abroad have made U.S. international tax rules increasingly salient for policymakers and U.S. MNEs. Income growth in developing countries has opened new markets for U.S. MNEs to sell goods and services. Improvements in infrastructure and information technology have lowered the cost of establishing certain business operations, such as manufacturing facilities, abroad. U.S. MNEs have grown increasingly reliant on global supply chains to produce goods more efficiently and to serve foreign markets more effectively.[157] In addition, foreign MNEs have risen in prominence and now compete with U.S. MNEs in many markets. These and other developments have put pressure on U.S. international tax rules to address and accommodate more complicated fact patterns concerning how U.S. MNEs organize themselves, serve foreign markets, and structure their production networks. Moreover, as U.S. MNEs generate increasing amounts of income abroad, their economic positions and investment decisions have become more sensitive to how their foreign-source income is taxed.

2. Neutrality conditions and their limits

When assessing international tax rules, economists generally start from the position that taxes distort economic activity to the extent that they change economic behavior in ways that result in inefficient levels or patterns of investment.[158] Analysts have settled on a number of general principles when it comes to evaluating whether tax rules promote economic efficiency in the purely domestic, closed-economy context. One general principle is that the pattern of aggregate investment may be more economically efficient if taxes are neutral with respect to the type of investment being made, or more specifically, if effective marginal rates of taxation are the same across investments. In particular, efficiency is enhanced if investments are made based on pre-tax rates of return rather than after-tax rates of return. If effective marginal rates of taxation vary by the type of investment made (*e.g.*, because of different cost recovery rules or investment incentives), that may result in an inefficient allocation of resources and lead to lower levels of production relative to a tax-neutral environment. Specifically, more resources flow to low-taxed sectors than would be the case if taxes were neutral with respect to types of investment, and fewer resources are devoted to more highly taxed sectors. This will generally lead to lower levels of productive efficiency in the economy and reduce national welfare.

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[157] For analysis of the growth in foreign value-added in U.S. manufactured products, see Robert Johnson, "Five Facts about Value-Added Exports and Implications for Macroeconomics and Trade Research," *Journal of Economic Perspectives*, vol. 28, no. 2, Spring 2014, pp. 119-142; and Pol Antras and Davin Chor, "Global Value Chains," *Handbook of International Economics*, vol. 5, Elsevier, forthcoming.

[158] Economists also recognize that taxes can be used to fund government spending and correct for market failures (*i.e.*, instances where the absence of government intervention results in too little or too much of an economic activity). See the discussion in Joint Committee on Taxation, *Economic Growth and Tax Policy* (JCX-47-15), February 2015, pp. 3-5.

In the cross-border, open-economy context, there is significantly less consensus on the principles that should be used to evaluate international tax policy. In the early economic literature, a number of neutrality conditions—the most prominent of which are capital export neutrality and capital import neutrality—were proposed to evaluate whether the international tax system promotes global (and not necessarily national) welfare.[159] The usefulness of these efficiency criteria or general guides to the development of international tax policy has been questioned by a number of commentators. Their validity relies on special (and not necessarily realistic) assumptions concerning the substitutability of domestic and foreign investment, how investments are made (*e.g.*, greenfield investments or acquisitions of existing companies), and intangible capital.[160] Moreover, some question whether principles used to evaluate whether international tax rules promote global welfare should be used by policymakers when designing their national tax systems, since policymakers may be more concerned with national, as opposed to global, welfare. Nonetheless, these neutrality principles are useful places to start when considering how to evaluate the international tax rules that a country adopts, and their limitations may shed light on what other principles or approaches may be more useful for analysis.

Capital export neutrality refers to a condition under which the overall effective tax rate on the return to investments made by a resident in any given country is the same regardless of where the investment is made. In other words, the decision made by a resident to invest at home or abroad is not influenced by tax considerations. As applied to U.S. international tax rules, this condition is generally met if the foreign-source income of U.S. residents is taxed at the same rate as their U.S.-source income, with unlimited foreign tax credits.

Capital import neutrality refers to a condition under which the overall effective tax rate on the return to investments made in any given country is the same regardless of the residence of the investor. As applied to U.S. international tax rules, this condition is met if foreign investments made by U.S. investors in any given country face the same overall tax burden as investments made by any other investor in that country. If the other investors are residents of that country or residents in countries that exempt foreign-source income from taxation, then capital import neutrality is satisfied if the United States exempts the foreign-source income of U.S. residents from taxation as well.

3. Evaluating international tax rules based on behavioral margins

Rather than evaluating tax systems based on whether they satisfy an overarching neutrality condition, recent economic research has focused on how international tax rules affect economic behavior in more specific dimensions of policy relevance, in particular those relating

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[159] The classic reference is Peggy B. Musgrave, *Taxation of Foreign Investment Income: An Economic Analysis*, Johns Hopkins Press, 1963.

[160] For a discussion of the usefulness of the neutrality conditions and the assumptions under which they can be used as efficiency criteria, see American Bar Association Task Force on International Tax Reform, "Report of the ABA Task Force on International Tax Reform," *Tax Law Review*, vol. 59, no. 3, 2005-2006, pp. 652-812; Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," John W. Diamond and George R. Zodrow (eds.), *Fundamental Tax Reform: Issue, Choices, and Implications*, the MIT Press, 2008, pp. 319-354; and David A. Weisbach, "The Use of Neutralities in International Tax Policy," *National Tax Journal*, vol. 68, no. 3, September 2015, pp. 635-652.

to preserving the income tax base and promoting domestic investment, employment, and growth. These dimensions, which are interrelated, include:

- Profit shifting
- The location of tangible investment
- The location of intangible property and returns to intangible investment, and research activity
- Earnings stripping, limitations on deductions, and investment
- The geographic direction of mergers and acquisitions ("M&As"), the location of business headquarters, and inversions
- Tax competition among countries

The remainder of Part III surveys the economic literature on these topics and describes how this literature may relate to the level of the U.S. corporate income tax rate, the GILTI inclusion and deduction, the deduction for FDII, and the BEAT. Since these provisions were recently enacted and have important differences with tax rules in other countries, studies analyzing the economic effects of these provisions are limited.

B. Profit Shifting

1. Background

As reflected in the OECD BEPS Project, policymakers are concerned that the location of profits derived from the sale of goods and services is not aligned with where the value underlying those goods and services was generated, thus reducing tax revenue. For example, in the United States, there has been a concern that a large share of U.S. corporate profits is located in low-tax jurisdictions where corporations have relatively little employment and tangible investment, even though the innovations generating those profits may have been developed in the United States.[161] Some commentators have noted that the geographic distribution of profits, even if legal, is at least partly artificial to the extent that it does not reflect where the real economic activity generating those profits is located.[162] Others have disputed this characterization and also contended that requiring a closer link between the location of profits and the location of real economic activity will cause U.S. corporations to shift U.S. employment and investment to low-tax jurisdictions and result in economic distortions.[163]

2. Location of reported profits

There is a large empirical literature analyzing the general question of how responsive the location of profits is to differences in tax rates across countries (without taking a position on where taxable income should be located as an economic matter). One survey of the literature finds that a one percentage-point reduction in the tax rate of a host country is predicted to lead to a 0.8 percent increase in the profits reported by a foreign subsidiary located in that country.[164] However, a number of the studies reviewed in the survey are limited in they (1) rely on financial statement data rather than tax data and (2) exclude from their analysis, because of data

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[161] For a discussion of the issues, see Gabriel Zucman, "Taxing across Borders: Tracking Personal Wealth and Corporate Profits," *Journal of Economic Perspectives*, vol. 28, no. 4, Fall 2014, pp. 121-148; and James R. Hines Jr., "Treasure Islands," *Journal of Economic Perspectives*, vol. 24, no 4, Fall 2010, pp. 103-126. An analysis of certain tax planning strategies MNEs may utilize to possibly shift income to low-tax jurisdictions can be found in Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[162] See Kimberly A. Clausing, "Profit Shifting before and after the Tax Cuts and Jobs Act," *National Tax Journal*, vol. 73, no. 4, December 2020, pp. 1233-1266.

[163] For a discussion on the possible limits of using the location of employment and investment as the basis for assessing where income is earned, see James R. Hines Jr., "Income Misattribution under Formula Apportionment," *European Economic Review*, vol. 54, no. 2, pp. 108-120. Some researchers have argued that methodological issues have caused estimates of profit shifting out of the United States to be overstated. See the discussion in Kimberly A. Clausing, "Profit Shifting before and after the Tax Cuts and Jobs Act," *National Tax Journal*, vol. 73, no. 4, December 2020, pp. 1233-1266.

[164] Josh H. Heckemeyer and Michael Overesch, "Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels." *Canadian Journal of Economics*, vol. 50, no. 4, November 2017, pp. 965-994. The methodology used in this paper was extended and updated in Sebastian Beer, Ruud de Moiij, and Li Liu, "International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots," *Journal of Economic Surveys*, vol. 34, no. 3, July 2020, pp. 660-688. This survey reports a slightly larger average estimate.

availability, a significant number of low-tax jurisdictions from their analysis. A recent paper analyzing tax return data from all U.S. CFCs reports a generally larger response of the location of profits to tax rate differentials, with the responsiveness dependent on the level of the host country tax rate.[165] The paper finds that a change in the host country tax rate from five percent to four percent results in a 4.7 percent increase in reported profits, while a change from 30 percent to 29 percent results in a 0.7 percent increase in reported profits.

3. Transfer pricing

Another set of papers has analyzed potential channels for profit shifting, particularly through how transfer prices are set. These papers examine the extent to which transfer prices, which should reflect arm's length prices, may deviate from arm's length prices. These studies generally rely on import and export price data collected by government agencies and compare prices charged to related and unrelated parties for similar products (although the related-party price data is sometimes estimated and not actually observed). An early study based on aggregate U.S. import and export price data (*i.e.*, across all companies for specific products) finds that a one percentage-point reduction in the tax rate of a destination country is associated with a 1.8 percent decrease in the related-party export price (relative to prices charged to unrelated parties), and that a one percentage-point reduction in the tax rate of an origin country is associated with a two percent increase in the related-party import price (relative to prices charged to unrelated parties).[166] A more recent study using firm-level Danish export data finds that a one percentage-point reduction in the tax rate of a low-tax country is associated with a 0.6 percent decrease in export prices of MNEs with affiliates in that country (relative to prices charged to unrelated parties).[167] Another recent study relying on firm-level tax and trade data from the United Kingdom finds that a one percentage-point increase in the tax rate of a destination country results in a three percent decrease in export prices charged to related parties (relative to unrelated parties), and that the decrease became 4.5 percent after the United Kingdom adopted a territorial tax system.[168] Using French tax and trade data, some economists find that the effect, with respect to the price of exported goods, mainly arises in exports to particularly low-tax jurisdictions and not elsewhere.[169] As the methodological approach across these papers varies,

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[165] Tim Dowd, Paul Landefeld, and Anne Moore, "Profit Shifting of U.S. Multinationals," *Journal of Public Economics*, vol. 148, no. 1, April 2017, pp. 1-13.

[166] Kimberly A. Clausing, "Tax-Motivated Transfer Pricing and US Intrafirm Trade Prices," *Journal of Public Economics*, vol. 87, nos. 9-10, September 2003, pp. 2207-2223.

[167] Anca D. Cristea and Daniel X. Nguyen, "Transfer Pricing by Multinational Firms: New Evidence from Foreign Firm Ownerships," *American Economic Journal: Economic Policy*, vol. 8, no. 3, August 2016, pp. 170-202.

[168] Li Liu, Tim Schmidt-Eisenlohr, and Dongxian Guo, "International Transfer Pricing and Tax Avoidance: Evidence from Linked Trade-Tax Statistics in the United Kingdom," *The Review of Economics and Statistics*, vol. 102, no. 4, October 2020, pp. 766-778.

[169] Ronald B. Davies, Julien Martin, Mathieu Parenti, and Farid Toubal, "Knocking on Tax Haven's Door: Multinational Firms and Transfer Pricing," *The Review of Economics and Statistics*, vol. 100, no. 1, March 2018, pp. 120-134.

the difference in results is not necessarily a reflection of differences in the tax sensitivity of transfer prices across countries.

4. Implications for U.S. international tax rules

CFC rules have been used to address profit shifting by reducing the tax advantage of locating profits in low-tax jurisdictions. In the U.S. context, the GILTI provisions (including the GILTI deduction) were intended, in part, to address potential base erosion that would result from the 100-percent DRD, and Joint Committee staff estimated the GILTI provisions to raise tax revenue.[170] One paper examining European MNEs finds that home-country CFC rules lowered profits reported in low-tax jurisdictions and increased profits in higher-tax jurisdictions. In addition, it estimates that half of the resulting increase in the tax base accrues to the home country enforcing the CFC rule (with the other half accruing to higher-tax jurisdictions as income is shifted out of low-tax jurisdictions).[171]

While the research on the effect of tax differentials on transfer prices has largely focused on inbound payments, one implication of the research is that tax differentials affect how transfer prices are set. To the extent that this is true, and to the extent that this interpretation of the research applies to outbound payments as well (*i.e.*, tax rate differentials may create an incentive to price outbound related-party payments at higher than arm's length prices), existing economic research may offer some support for one possible motivation for enacting the BEAT (*i.e.*, limiting the ability of foreign corporations from taking advantage of certain deductions).[172] However, these results may have limited applicability to the BEAT because (1) base erosion payments under the BEAT are not affected by the home-country tax rate of the related party and (2) the studies focused on the pricing of goods.

[170] Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act"* (JCX-67-17), December 2017. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[171] Sarah Clifford, "Taxing Multinationals beyond Borders: Financial and Locational Responses to CFC Rules," *Journal of Public Economics*, vol. 173, no. 1, May 2019, pp. 44-71.

[172] Committee Recommendations as Submitted to the Committee on the Budget Pursuant to H. Con. Res. 71, S. Prt. 115-20, p. 396.

C. Location of Tangible Investment

1. Background

U.S. policymakers are often concerned with promoting economic growth and the general economic well-being of the U.S. population, both of which are influenced significantly by the level of investment in the United States. Domestic investment arises from several sources, including the activities of U.S. MNEs and other U.S. businesses as well as the U.S. activities of foreign MNEs. In turn, these investment decisions may be based on a number of factors, including: the quality of the U.S. workforce and the cost of labor; their expected sales growth both in the United States and abroad (*i.e.*, the demand for their goods and services); the location of both their customers and their suppliers; taxes; and the economic benefits of locating activities in particular areas, such as a geographic region (*e.g.*, Silicon Valley), because, for example, of existing research networks and proximity to universities.

2. Host-country taxation and the location of tangible investment

In the cross-border context, there are a number of ways in which a company can make an investment in a foreign country: (1) increase investment through an existing foreign affiliate, (2) establish a new foreign affiliate (*i.e.*, greenfield investment), or (3) acquire an existing company operating in that country. This section focuses on methods (1) and (2) and reviews the economic literature on taxation and the location of tangible investment. Part III.F of this document reviews the literature on the effect of taxation on M&As (*i.e.*, portfolio investment).

Economists have generally found that the location of cross-border tangible investment is fairly responsive to host country taxation (*i.e.*, the tax rules of the foreign country in which the investment is being made).[173] For example, one early study of U.S. MNEs finds that, once a U.S. MNE chooses to locate production in Europe, effective average tax rates in potential host countries have a significant effect on its choice of where in Europe to locate production.[174] However, these tax rates do not have a significant effect on the initial decision to locate production in Europe or elsewhere. A more recent paper examining German MNEs finds that a 10 percent increase in the host country's statutory corporate income tax rate is associated with a 6.4 percent lower probability of a German MNE locating new production there.[175] One study on European MNEs, which more explicitly accounts for host-country corporate income tax rates and

[173] For reviews of the literature, see Ruud A. de Mooij and Sjef Ederveen, "Corporate Tax Elasticities: A Reader's Guide to Empirical Findings," *Oxford Review of Economic Policy*, vol. 24, no. 4, Winter 2008, pp. 680-697; and Lars P. Feld and Jost H. Heckemeyer, "FDI and Taxation: A Meta-Study," *Journal of Economic Surveys*, vol. 25, no. 2, April 2011, pp. 233-272.

[174] Michael P. Devereux and Rachel Griffith, "Taxes and the Location of Production: Evidence from a Panel of US Multinationals," *Journal of Public Economics*, vol. 68, no. 3, June 1998, pp. 335-367. The study finds that average tax rates in Europe do not have an effect on the initial decision of whether to locate production in Europe or elsewhere (or not all).

[175] Shafik Hebous, Martin Ruf, Alfons J. Weichenreider, "The Effects of Taxation on the Location Decision of Multinational Firms: M&A Versus Greenfield Investments," *National Tax Journal*, vol. 64, no. 3, September 2011, pp. 817-838.

host-country withholding tax rates (as well as any additional home-country tax), finds that all three taxes have a negative effect on the decision of a European MNE to locate a subsidiary in a particular country.[176]

3. Home-country taxation and the location of tangible investment

Economists have also analyzed how home-country tax rules affect the investment decisions of MNEs, with more recent papers generally finding that tangible investment in lower-tax jurisdictions responds negatively to CFC rules (*i.e.*, rules that subject foreign-source income to full home-country tax) but positively to rules exempting foreign-source income from tax. One paper examining German CFC rules—which subject foreign-source income to full German tax if certain criteria are met—finds that they have a negative effect on the amount of tangible investment German MNEs locate in countries where the CFC rules are triggered (typically countries with a lower statutory tax rate than Germany's).[177] Another paper, analyzing CFC rules in a larger set of countries, also finds that they have a negative effect on tangible investment in lower-tax countries.[178] In contrast, a study on the investment decisions of U.K. MNEs after the United Kingdom shifted to an exemption system estimates that the shift increased the investment rate of U.K. MNEs by 16.7 percentage points in low-tax countries (*i.e.*, countries with a lower statutory tax rate than the United Kingdom's), but did not affect the level of investment in high-tax countries or in the United Kingdom.[179]

Apart from rules related to cross-border taxation, a parent company's home-country corporate tax rate may also affect investment in its affiliates, as some research has shown that complementarity may exist between foreign and domestic investment of MNEs.[180] A study using data on European MNEs estimates that a 10 percentage-point increase in a parent

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[176] Salvador Barrios, Harry Huizinga, Luc Laeven, Gaetan Nicodeme, "International Taxation and Multinational Firm Location Decisions," *Journal of Public Economics*, vol. 96, nos. 11-12, December 2012, pp. 946-958.

[177] Peter Egger and Georg Wamser, "The Impact of Controlled Foreign Company Legislation on Real Investments Abroad: A Multi-Dimensional Regression Discontinuity Design," *Journal of Public Economics*, vol. 129, no. 1, September 2015, pp. 77-91.

[178] Sarah Clifford, "Taxing Multinationals beyond Borders: Financial and Locational Responses to CFC Rules," *Journal of Public Economics*, vol. 173, no. 1, May 2019, pp. 44-71.

[179] Li Liu, "Where Does Multinational Investment Go with Territorial Taxation? Evidence from the United Kingdom," *American Economic Journal: Economic Policy*, vol. 12, no. 1, February 2020, pp. 325-358.

[180] For evidence on the impact of U.S. MNE foreign investment and employment on domestic investment and employment, see Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Domestic Effects of the Foreign Activities of US Multinationals," *American Economic Journal: Economic Policy*, vol. 1, no. 1, February 2009, pp. 181-203. For evidence from German MNEs and their affiliates, see Stefan Goldbach, Arne J. Nagengast, Elias Steinmuller, and Georg Wamser, "The Effect of Investing Abroad on Investment at Home: On the Role of Technology, Tax Savings, and Internal Capital Markets," *Journal of International Economics*, vol. 116, no. 1, January 2019, pp. 58-73.

company's home-country corporate tax rate is associated with a 5.6 percent decrease in a foreign affiliate's capital stock.[181]

4. Implications for U.S. international tax rules

Based on existing research, the reduction in the U.S. corporate tax rate to 21 percent would be expected to raise tangible investment by foreign MNEs in the United States. However, the economic literature has less to say about the effects of the GILTI provisions on outbound tangible investment by U.S. MNEs. Although several papers find that CFC rules can discourage outbound tangible investment, those CFC rules generally subjected foreign-source income to full home-country taxation rather than a lower rate of tax. In contrast to these CFC rules, the GILTI provisions (1) effectively exempt a certain amount of income (based on qualified business asset investment) from taxation regardless of the rate at which the CFC is taxed and (2) allow for a 50-percent deduction on the remaining foreign-source income that is included as GILTI. This type of CFC rule is relatively novel among developed countries and, as a result, has been subject to less empirical research.

[181] Johannes Becker and Nadine Riedel, "Cross-Border Tax Effects on Affiliate Investment: Evidence from European Multinationals," *European Economic Review*, vol. 56. No. 3, April 2012, pp. 436-450.

D. Location of Intangible Property and the Returns to Intangible Investment, and Research Activity

1. Background

The taxation of income derived from intangible property has become a central issue in international tax policy discussions for at least two reasons. First, the returns to intangible property are a particularly mobile source of income and account for a significant share of profits reported by MNEs.[182] Second, the research activity associated with the development of intangible property is an important driver of innovation and economic growth.[183] In the U.S. context, part of the policy motivation for enacting the deduction for FDII, along with the parallel deduction for GILTI, is to encourage the location of more intangible income, and potentially some of the activity giving rise to that intangible income, in the United States, and make the U.S. tax system more neutral with respect to where U.S. MNEs locate intangible property and income (under the view that the United States was a less favorable location under prior law).[184]

2. Location of intangible property

There is evidence that the location of certain intangible property within MNEs is sensitive to tax policy. A series of papers studying European MNEs and their intangible property holdings finds that they tend to hold more intangible property in affiliates located in lower-tax jurisdictions and have fewer patent filings in affiliates located in higher-tax jurisdictions.[185] However, these papers do not answer the question of whether lower tax rates result in increased overall levels of intangible property in the MNE group. In contrast to these findings on intangible property in European MNEs, one paper studying corporations listed in the Standard and Poor's 500 Index finds that U.S. marginal tax rates have no significant effect on where U.S. trademarks are held, and that offshore trademark ownership is influenced more by foreign

[182] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, vol. 56, no. 1, pt. 2, March 2003, pp. 221-242. These profits may also be a source of wage growth. One paper examining surplus profits arising from patent allowances finds that workers capture, in the form of higher earnings, approximately 30 cents of every dollar of surplus generated from the patent. See Patrick Kline, Neviana Petkova, Heidi Williams, and Owen Zidar, "Who Profits from Patents? Rent-Sharing at Innovative Firms" *Quarterly Journal of Economics*, vol. 134, no. 3, August 2019, pp. 1343-1404.

[183] The benefits of U.S. research activity are largely localized but may also be diffused internationally. One study finds that the median U.S. multinational firm realizes 20 percent of the return to its U.S. research and development investment abroad. See L. Kamran Bili and Eduardo Morales, "Innovation in the Global Firm," *The Journal of Political Economy*, vol. 128, no. 4, April 2020. Note that intangible property may include property, such as certain marketing intangibles, that do not result from scientific research.

[184] Committee Recommendations as Submitted to the Committee on the Budget Pursuant to H. Con. Res. 71, S. Prt. 115-20, p. 375

[185] Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets within Multinational Firms," *Journal of Public Economics*, vol. 95, nos. 7-8, August 2011, pp. 691-707; and Tom Karkinsky and Nadine Riedel, "Corporate Taxation and the Choice of Patent Location within Multinational Firms," *Journal of International Economics*, vol. 88, no. 1, September 2012, pp. 176-185.

activities than tax rates.[186] In particular, for trademarks held offshore, host-country taxes have a significant effect on location choice only if U.S. CFC rules do not apply. The U.S. trademark locations of European MNEs, however, are more responsive to U.S tax rates.

3. Patent boxes and research activity

From the perspective of investment, employment, and economic growth, the research activities associated with intangible property are potentially more important than where the intangible property is located. A number of countries have adopted "patent boxes" that offer preferential treatment to income generated from patents that are located in those countries, and research on patent boxes may offer insight into whether the location of intangible property is accompanied by increased research activities. In contrast to some of the overarching results in the papers described above, one paper has found that patent boxes have a small effect on patent transfers (with more noticeable effects for patent boxes that do not have any local development requirement), but have no effect on research spending and patented inventions in the countries offering patent boxes.[187] Another paper predicts that patent boxes may encourage the location of new patents but lead to significant losses in tax revenue.[188] One survey of economic research on policies to promote innovation finds that, from a tax policy perspective, research credits are relatively effective tools to promote research spending, but the cost of patent boxes outweighs their benefits.[189] Therefore, existing economic research suggests that preferential rates on patent-related income may not increase research activity.

4. Implications for U.S. international tax rules

To the extent that (1) taxes influence the location of intangible property and (2) the location of intangible income follows the location of intangible property, preferential rates on intangible income offered by a country may result in more intangible income being located in that country. The application of this result to the deduction for FDII (paired with the deduction for GILTI) is unclear because the calculation of deemed intangible income is formulaic and not based on items of income tied to intangible property. In addition, only a portion of deemed intangible income, depending on foreign income derived by the U.S. corporation, benefits from the FDII deduction, while the taxes studied in the economics literature on the effect of taxation

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[186] Jost H. Heckemeyer, Pia Olligs, Michael Overesch, "'Home Sweet Home' Versus International Tax Planning: Where Do Multinational Firms Hold Their U.S. Trademarks?" *National Tax Journal*, vol. 71, no. 3, September 2018, pp. 485-520.

[187] Fabian Gaessler, Bronwyn H. Hall, and Dietmar Harhoff, "Should There Be Lower Taxes on Patent Income?" *Research Policy*, vol. 50, no. 1, January 2021, pp. 104-129. Some of the research surveyed in this paper was conducted prior to the OECD agreement on the Modified Nexus Approach for patent boxes, which requires a link between research spending and the intangible property underlying the patent-related income receiving the tax benefit.

[188] Rachel Griffith, Helen Miller, Martin O'Connell, "Ownership of Intellectual Property and Corporate Taxation," *Journal of Public Economics*, vol. 112, no. 1, April 2014, pp. 12-23.

[189] Nicholas Bloom, John Van Reenen, and Heidi Williams, "A Toolkit of Policies to Promote Innovation," *Journal of Economic Perspectives*, vol. 33, no. 3, Summer 2019, pp. 163-184.

on the location of intangible property generally apply to all intangible-related income (and sometimes all income) earned by the company.

A separate line of economic research relevant to the deduction for FDII has found that it is potentially pro-cyclical—with the value of the deduction relative to income rising during periods of economic expansion and falling during recessions—and highly dependent on the demand for U.S. exports. In addition, the deduction may be highly concentrated among taxpayers, with a large portion of the benefit going to the top one percent of beneficiaries.[190]

[190] Tim Dowd and Paul Landefeld, "The Business Cycle and the Deduction for Foreign Derived Intangible Income: A Historical Perspective," *National Tax Journal*, vol. 71, no. 4, December 2018, pp. 729-750.

F. Earnings Stripping, Limitations on Deductions, and Investment

1. Background

While the shifting of profits from the United States to other countries may erode the U.S. tax base, policymakers may also be concerned when corporations reduce U.S. tax by locating (or increasing) deductions in the United States for tax reasons; interest deductions have been of particular concern. Changes in U.S. tax law since 2017, such as the reduction in the corporate tax rate as well as the limitations on interest expense deductions under section 163(j), have limited the tax benefit of locating interest deductions in the United States. Under section 163(j), a taxpayer's interest deduction is generally limited to the sum of (1) business interest income and (2) 30 percent of the taxpayer's adjusted taxable income.[191]

A large amount of research has examined how tax affects the location of debt and interest deductions. A subset of this research has looked at the relationship between cross-border interest limitation rules—which can be viewed as tax increases—and host-country investment, which may have implications for understanding the economic effects of the BEAT.

2. Earnings stripping

Corporations typically finance their operations through debt, equity, or a mix of both. While corporations can deduct interest payments made to holders of their debt, they cannot deduct dividend payments made to their equity investors. The differing tax treatment of debt relative to equity may encourage firms to borrow more than they would absent tax considerations. Some researchers have estimated that the value of the interest deduction can account for up to 10 percent of a firm's value, and that firms can increase their value by borrowing more, although some studies have concluded that these estimates are overstated and that firms generally have tax-efficient capital structures.[192]

Debt may be a tax-favored source of financing for corporations regardless of whether they have purely domestic operations or also operate overseas. However, for those corporations that do operate overseas, debt may also serve as a mechanism for earnings stripping from high-tax jurisdictions to low-tax jurisdictions. This can be achieved, for example, if a foreign-controlled U.S. corporation borrows from a related foreign affiliate located in a low-tax jurisdiction. In this case, the interest expense incurred by the U.S. corporation may be deductible, but the interest income received by the related foreign affiliate may be includible at a low tax rate. A similar result is more difficult for U.S.-controlled corporations to achieve, because the interest income received by CFCs is generally taxed as subpart F income, and because a loan to the U.S. parent corporation is generally considered an investment in U.S. property subject to inclusion under section 956. Therefore, even though both purely domestic corporations and multinational corporations may borrow more because interest expenses can be

[191] Sec. 163(j)(8)

[192] For a discussion, see John Graham, "Do Taxes Affect Corporation Decisions? A Review," in G.M. Constantinides, Milton Harris, and Rene M. Stulz (eds.), *Handbook of the Economics of Finance*, vol. 2A, North-Holland Publishing Co., 2013, pp. 123-210.

deducted, multinational corporations have an additional incentive to increase leverage if they can strip earnings from high-tax jurisdictions to low-tax jurisdictions through related-party borrowing. A number of empirical studies support the conclusion that multinationals are more leveraged in high-tax jurisdictions.[193] One survey of the literature finds that a one percentage point higher corporate tax rate is associated with an increase of the debt-to-asset ratio by between 0.17 and 0.28.[194] Studies have also found that internal borrowing is more sensitive to taxes than external borrowing, which is consistent with the hypothesis that multinational corporations can, and do, exercise greater latitude with borrowing in high-tax jurisdictions than purely domestic corporations.[195] However, these results do not separately identify overleveraging arising from (1) the differential tax treatment of debt relative to equity and (2) earnings stripping. One general prediction from the economics literature is that the leverage of a corporation increases as the tax rate it faces increases, since the value of interest deductions rises with the corporate tax rate.[196] Therefore, even in the absence of earnings-stripping motives, a multinational corporation's optimal capital structure may involve higher leverage in high-tax jurisdictions than low-tax jurisdictions.

3. Thin-capitalization rules

Several foreign countries have adopted thin-capitalization rules that aim to limit the amount debt corporations locate in their country. While the thin-capitalization rules differ in design, they generally limit interest deductions for loans from related parties if a corporation's debt-to-equity ratio exceeds a certain ratio.

Economists generally find that thin-capitalization rules reduce related-party debt, increase external debt, and reduce debt-to-equity ratios (*i.e.*, the reduction in related-party debt exceeds the increase in external debt).[197] As thin-capitalization rules effectively increase the tax cost of conducting business in a country by potentially curtailing interest deductions, economists have

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[193] For example, see Harry Huizinga, Luc Laeven, and Gaeten Nicodeme, "Capital Structure and International Debt Shifting," *Journal of Financial Economics*, vol. 88, no. 1, April 2008, pp. 80-118; and Michael Faulkender and Jason M. Smith, "Taxes and Leverage at Multinational Corporations," *Journal of Financial Economics*, vol. 122, no. 11, October 2016, pp. 1-20. On the particular point of earnings stripping in the United States, a 2007 study by the U.S. Treasury finds evidence of earnings stripping for inverted corporations but does not find "conclusive evidence" of earnings stripping for foreign-controlled domestic corporations that had not inverted. See Department of the Treasury, *Report to Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, November 2007.

[194] Ruud A. de Mooij, "The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations," *IMF Working Paper*, no. 11/95, April 2011.

[195] Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets," *The Journal of Finance*, vol. 59, no. 6, December 2004, pp. 2451-2487.

[196] Jennifer Blouin, John E. Core, and Wayne Guay, "Have the Tax Benefits of Debt Been Overestimated?" *Journal of Financial Economics*, vol. 98, no. 2, November 2010, pp. 195-213.

[197] Thiess Buettner, Michael Overesch, Ulrich Schreiber, and Georg Wamser, "The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms," *Journal of Public Economics*, vol. 96, nos. 11-12, December 2012, pp. 930-938.

also examined how they affect investment and employment. A series of papers using data on German MNEs and their affiliates finds that thin-capitalization rules in a foreign country have a negative effect on (1) the decision of German MNEs to locate their first foreign affiliate in that country and (2) employment and investment in property, plant, and equipment in that country.[198]

4. Implications for U.S. international tax rules

The research described in this section may inform analysis of the expected effects of the BEAT, which can be viewed as a tax increase that is partly a function of the amount of related-party payments a corporation makes. To the extent that the BEAT, like thin-capitalization rules, increase the tax cost of foreign MNEs operating in the United States, it may be expected to reduce the amount of investment and employment in the United States by foreign MNEs.[199] However, the BEAT operates very differently than thin-capitalization rules and includes variables beyond related-party payments. Moreover, studies on thin-capitalization rules largely rely on German data with relatively sparse tax information.

[198] Valeria Merlo, Nadine Riedel, Georg Wamser, "The Impact of Thin-Capitalization Rules on the Location of Multinational Firms' Foreign Affiliates," *Review of International Economics*, vol. 28, no. 1, February 2020, pp. 35-61; and Thiess Buettner, Michael Overesch, and Georg Wamser, "Anti Profit-Shifting Rules and Foreign Direct Investment," *International Tax and Public Finance*, vol. 25, June 2018, pp. 553-580. The first paper also finds that tax rate changes have a larger effect on location decisions than equivalent tax base changes.

[199] A similar point can be made with respect to interest limitations under section 163(j).

G. The Geographic Direction of Mergers and Acquisitions, the Location of Headquarters, and Inversions

1. Background

Partly in response to proposed or executed inversion transactions—*e.g.*, where a U.S. corporation acquires a smaller foreign corporation, and the parent company of the combined group is a foreign corporation for U.S. tax purposes—policymakers have been concerned that U.S. international tax rules may put U.S. MNEs at a competitive disadvantage by making U.S.- and foreign-sited assets more valuable under foreign ownership rather than U.S. ownership. Some economists have also proposed that tax rules be evaluated based on whether they are neutral with respect to an asset owner's residence.[200] To the extent that U.S. tax rules disadvantage U.S. ownership of an asset, these economists argue that making them more neutral would make the global pattern of asset ownership more productive.[201] For example, assume an asset would generate higher pre-tax returns when owned by an MNE based in a high-tax jurisdiction compared an MNE in a low-tax jurisdiction. As a result, it is more globally efficient for the high-taxed MNE to own the asset. However, if the asset's after-tax return is higher in the hands of the MNE located in the low-tax jurisdiction, then to the extent that the value of an asset to potential owners is based only on its after-tax returns, and to the extent that bids for assets are based on that value, the low-taxed MNE may own the asset, leading to global economic inefficiency. Some research has found that firm productivity is reduced when there is an increase in the tax rate difference between a target's country and an acquirer's country.[202] The theory is that resources are allocated away from the higher-taxed entity to the lower-taxed entity up to the point where after-tax returns between the two entities are equalized.[203] Pre-tax returns, however, would not be equalized, and thus the reallocation of investment is inefficient. This would suggest that equalizing the tax treatment of business income across countries promotes efficiency, which may not be practical (and also demonstrates some of the potential limits to applying neutrality conditions).

Economic research on (1) the effect of taxation on the geographic direction of cross-border M&A and (2) the potentially different economic effects of U.S. and foreign ownership of U.S.- and foreign-sited assets may shed light on the validity of these positions.

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[200] See Mihir A. Desai and James R. Hines Jr., "Evaluating International Tax Reform," *National Tax Journal*, vol. 56, no. 3, September 2003, pp. 487-502; and Dhammika Dharmapala, "The Consequences of the Tax Cut and Jobs Act's International Provisions: Lessons from Existing Research," *National Tax Journal*, vol. 71, no. 4, December 2018, pp. 707-728.

[201] *Ibid*.

[202] Maximilian Todtenhaupt and Johannes Voget, "International Taxation and Productivity Effects of M&As," *Journal of International Economics*, forthcoming.

[203] *Ibid*.

2. Effect of taxes on the volume and geographic direction of M&A transactions

Economic research generally finds that taxes have an effect on the volume and geographic direction of cross-border M&A transactions. Based on data relating to cross-border M&A transactions involving companies headquartered in Japan, the United States, or a European country, some economists find additional home-country taxation of foreign-source income (1) reduces the likelihood that the parent company in a cross-border M&A transaction is located in that home country and (2) lowers takeover premiums of M&A targets located in that country.[204] Another study, relying on data largely covering the United States and certain European countries, finds host-country tax rates have a negative effect on the decision of corporations expanding through M&A to acquire companies in that host country.[205] Focusing on the transition of Japan and the United Kingdom from worldwide tax systems to territorial tax systems, one paper finds that eliminating the tax on dividend repatriations increased the number of Japanese MNE acquisitions of foreign targets by 16.1 percent and the number of U.K. MNE acquisitions of foreign targets by 1.6 percent.[206]

Some studies relying specifically on M&A transactions involving U.S. companies reach similar conclusions and find that taxes affect M&A activity. One study finds that an increase in repatriation tax costs under prior law increased the probability a U.S. MNE acquired a foreign (but not domestic) target. Since the 2017 changes in U.S. international tax rules generally eliminated the tax cost of repatriation but also imposed current taxation on GILTI at a reduced rate, it is unclear whether this study's results imply that U.S. MNEs will engage in fewer foreign acquisitions and more domestic acquisitions, however.[207] One paper, examining the effect of lower effective U.S. corporate tax rates on M&A transactions in the United States, finds that lower taxes increased the amount of money U.S. companies (predominantly U.S. MNEs) spent on acquisitions of U.S. companies, largely by increasing available cash of potential acquirers.[208]

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[204] See Harry P. Huizinga and Johannes Voget, "International Taxation and the Direction and Volume of Cross-Border M&As," *The Journal of Finance*, vol. 54, no. 3, June 2009, pp. 1217-1249; and Harry Huizinga, Johannes Voget, and Wolf Wagner, "Who Bears the Burden of International Taxation: Evidence from Cross-Border M&As," *Journal of International Economics*, vol. 88, no. 1, September 2012, pp. 186-197.

[205] Wiji Arulampalam, Michael P. Devereux, and Federica Liberini, "Taxes and the Location of Targets," *Journal of Public Economics*, vol. 176, no. 1, pp. 161-178.

[206] Lars Feld, Martin Ruf, Uwe Scheuering, Ulrich Schreiber, and Johannes Voget, "Repatriation Taxes and Outbound M&As," *Journal of Public Economics*, vol. 139, no. 1, July 2016, pp. 13-17. The sample consists of cross-border M&A transactions between companies located in OECD countries from 2004 to 2013.

[207] Some economists have suggested that the GILTI provisions and the 100-percent DRD, though eliminating the tax cost of repatriation, may not increase investment, based on the lack of increased investment from the 2004 repatriation holiday. See Alan J. Auerbach, "Measuring the Effects of Corporate Tax Cuts," *Journal of Economic Perspectives*, vol. 32, no. 4, Fall 2018, pp. 97-120.

[208] Jennifer L. Blouin, Eliezer M. Fich, Edward M. Rice, and Anh L. Tran, "Corporate Tax Cuts, Merger Activity, and Shareholder Wealth," *Journal of Accounting and Economics*, vol. 71, no. 1, February 2021. The authors use the prior-law section 199 domestic activities production deduction as their measure of a corporate tax rate reduction.

3. Economic effects of U.S. or foreign ownership of U.S.- or foreign-sited assets

General considerations

The size of the U.S. tax base is directly related to whether U.S.- and foreign-sited assets are owned by U.S. MNEs or foreign MNEs. When a foreign MNE acquires a U.S. MNE, foreign-source income derived from overseas expansion of activities linked to the U.S. MNE may fall outside the U.S. tax base, and instead be part of the tax base of the foreign MNE's home country.[209] As a result, the acquisition of a U.S. MNE by a foreign MNE may reduce the U.S. tax base relative to situations where that U.S. MNE is acquired by another U.S. MNE or not acquired at all. Similarly, the potential U.S. tax base is smaller when a foreign MNE is acquired by another foreign MNE, rather than a U.S. MNE.

With regards to foreign assets, U.S. ownership may increase U.S. investment and employment relative to foreign ownership of those assets. Foreign assets may serve as a platform for overseas expansion and growth, potentially increasing domestic employment and investment. In addition, when a U.S. company acquires a foreign company, it may also be acquiring intangibles (such as intellectual property and managerial know-how) that complement its existing U.S. operations and enhance their effectiveness.

Relative to situations involving U.S. ownership of a foreign asset, it is less clear how, as a general matter, U.S. ownership of a U.S. asset increases U.S. investment and employment more than foreign ownership of a U.S. asset. In addition, since a large share (estimated to be 26 percent in 2015) of U.S. stock is held by foreigners, a large share of financial gains made by U.S. MNEs may accrue abroad.[210] Some may argue that a foreign-owned U.S. company may hire fewer U.S. workers, or invest less in the United States, than would be the case if that company had a U.S. parent. However, to the extent that the parent—U.S. or foreign—of the U.S. subsidiary is charged with maximizing shareholder value, the parent should make employment and investment decisions based on what maximizes profits at the subsidiary, and without further regard to where those economic activities take place (at least to a first approximation). In other words, both the potential U.S. and foreign parents will hire the most qualified workers, and make the most productive investments, regardless of nationality or location. However, if the potential U.S. parent and foreign parent have operational differences, these differences could influence U.S. investment and employment. For example, when a foreign company acquires a U.S. company, the headquarter operations of the U.S. company may be reduced or moved outside the United States if operations are managed more effectively where the foreign parent's central management is located. This may result in direct employment losses in the United States.

[209] Congressional Budget Office, *An Analysis of Corporate Inversions*, September 2017.

[210] For the estimate of foreign holdings of U.S. stock, see Steven M. Rosenthal and Lydia S. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," *Tax Notes*, May 16, 2016, pp. 923-934.

Empirical studies

Headquarters

There is economic research documenting the value attributable to headquarters. One study of European MNEs finds that their headquarters are 25 percent more profitable than their foreign subsidiaries, with the profitability gap decreasing by approximately one percentage point each year.[211] Another study, based on data on the headquarter locations of publicly traded U.S. firms and receipts of local charitable organizations, finds that a $1,000 increase in the market value of firms headquartered in a city results in between $0.60 and $1.60 in additional contributions to local non-profits.[212] Proximity to headquarters can also improve productivity. One paper analyzing business operations in the United States finds that the introduction of a new airline route that reduces travel time between headquarters and plants increases plant-level investment by eight percent to nine percent and plants' productivity by between 1.3 percent and 1.4 percent.[213]

A related line of research has studied the distribution of MNE activity between parents and affiliates. One survey of the literature reports that (1) economic activity within an MNE group is concentrated in the parent country and (2) parent firms are relatively specialized in research and development activities while affiliates specialize in serving foreign markets.[214]

It is unclear the extent to which tax drives the location of headquarters. While the studies described in Part III.C.2 find that taxes affect the location of production, they have less to say about how taxes affect the location of headquarters. One descriptive study finds no relationship between tax rates and the location of *Fortune 500* firms. Another descriptive study documents that, of the 918 U.S. headquartered MNCs engaged in an IPO in the United States between 1997 and 2010, 874 were incorporated in the United States and 27 were incorporated in jurisdictions the authors describe as tax havens.[215] The authors of this study suggest that one would expect more incorporations in these tax havens if the tax burden of U.S. residence was particularly large relative to the tax burden of residence in other jurisdictions during this time.

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[211] Matthias Dischinger, Bodo Knoll, and Nadine Riedel, "There's No Place Like Home: The Profitability Gap between Headquarters and Their Foreign Subsidiaries," *Journal of Economics and Management Strategy*, vol. 23, no. 2, Summer 2014, pp. 369-395.

[212] David Card, Kevin F. Hallock, and Enrico Moretti, "The Geography of Giving: The Effect of Corporate Headquarters on Local Charities," *Journal of Public Economics*, vol. 94, nos. 3-4, April 2010, pp. 222-234.

[213] Xavier Giroud, "Proximity and Investment: Evidence from Plant-Level Data," *Quarterly Journal of Economics*, vol. 128, no. 2, May 2013, pp. 861-915.

[214] Stephen Ross Yeaple, "The Multinational Firm," *Annual Review of Economics*, vol. 5, 2013, pp. 193-217.

[215] Eric J. Allen and Susan C. Morse, "Tax-Haven Incorporation for U.S.-Headquartered Firms: No Exodus Yet," *National Tax Journal*, vol. 66, no. 2, June 2013, pp. 395-420. Of the

Foreign ownership and economic activity

A large body of economic research has examined the effect of foreign ownership on the economic activity of acquired firms. One paper using data on Spanish firms finds that relative to Spanish firms not acquired by a foreign company, foreign-acquired Spanish firms increase sales by 18 percent and labor productivity by 11 percent.[216] The authors find that acquisition by foreign companies gave the Spanish firms access to larger markets and resulted in greater levels of innovative activities (*e.g.*, process innovation, new methods of organization production, and product innovation). Research has also distinguished between the effect of greenfield investments and the effect of acquisitions on host-country productivity. One study using data on Norwegian firms finds that greenfield entry has a negative effect on the productivity of domestic plants, but foreign entry through acquisition has a positive effect on productivity.[217] The authors of that study hypothesize that greenfield entrants compete in both the product and labor market with domestic firms, while foreign acquirers can rely on pre-existing economic relationships. Another study, using data on Swedish firms, finds that acquired affiliates have greater levels of research activity than greenfield affiliates.[218] The generally positive effects of foreign ownership in these papers is consistent with a study finding that firms making greenfield investments are more efficient than those making cross-border acquisitions.[219] In addition, some papers emphasize that firms would not engage in M&A transactions unless they expected economic benefits (*e.g.*, productivity improvements).[220]

However, some research has reached different conclusions and has found that foreign ownership can have negative effects on domestic economic activity. One paper examining a sample of small- and medium-sized German firms finds that foreign acquisitions have a negative effect on average research expenditures, and that innovation is not affected by foreign ownership.[221] Research based on cross-border M&A transactions between European firms finds that the merged entity experiences an increase in innovation, but the effect is driven by an

[216] Maria Guadalupe, Olga Kuzmina, and Catherine Thomas, "Innovation and Foreign Ownership," *American Economic Review*, vol. 102, no. 7, December 2012, pp. 3594-3627.

[217] Raghnhild Balsvik and Stefanie Haller, "Foreign Firms and Host-Country Productivity: Does the Mode of Entry Matter," *Oxford Economic Papers*, vol. 63, no. 1, January 2011, pp. 158-186.

[218] Olivier Bertrand, Katariina Nilsson Hakkala, Pehr-Johan Norback, and Lars Persson, "Should Countries Block Foreign Takeovers of R&D Champions and Promote Greenfield Entry," *Canadian Journal of Economics*, vol. 45, no. 3, August 2012, pp. 1083-1124.

[219] Volcker Nocke and Stephen Yeaple, "An Assignment Theory of Foreign Direct Investment," *The Review of Economic Studies*, vol. 75, no. 2, April 2008, pp. 529-557.

[220] Joel David, "The Aggregate Implications of Mergers and Acquisitions," *The Review of Economic Studies*, forthcoming.

[221] Joel Stiebale and Frank Reize, "The Impact of FDI through Mergers and Acquisitions on Innovation in Target Firms," *International Journal of Industrial Organization*, vol. 29, no. 2, March 2011, pp. 155-167.

increase in innovation in the acquirer's country; innovation in the target's country tends to decrease.[222]

While the papers described above examine the impact of foreign MNE acquisition of a domestic firm, they do not address the question of whether the acquisition by a foreign MNE is preferable to an acquisition by a home-country MNE from the perspective of increasing domestic investment, employment, and growth. The research on this particular question is limited. One study based on U.S.-acquired firms finds that U.S. targets acquired by foreign MNEs based in developed countries have higher labor productivity, average profits, and employment than targets acquired by U.S. MNEs.[223] One limitation of this study, and the studies in this section on foreign ownership of domestic firms generally, is that firms are fairly complicated assets, and as a result there may be significant differences between firms acquired by foreign MNEs, firms acquired by home-country MNEs, and unacquired firms that cannot be accounted for using financial statement data alone.

[222] Joel Stiebale, "Cross-Border M&As and Innovative Activity of Acquiring and Target Firms," *Journal of International Economics*, vol. 99, no. 1, March 2016, pp. 1-15.

[223] Wenjie Chen, "The Effect of Investor Origin on Firm Performance: Domestic and Foreign Direct Investment in the United States," *Journal of International Economics*, vol. 83, no. 2, March 2011, pp. 219-228.

H. Tax Competition among Countries

1. Background

U.S. international tax rules are set in an environment where policymakers (1) generally aim to make the United States a more attractive location for investment by U.S. and foreign MNEs but (2) are potentially concerned that, by lowering corporate income taxes to accomplish this goal, they are participating in a "race to the bottom" with other countries that may reduce tax revenue without increasing U.S. economic activity. The economics literature on tax competition contributes to this discussion by examining the response of countries to changes in taxes in other countries as well as the design of capital income taxes in a world with countries competing for inbound investment (among other topics).[224]

2. Tax competition, tax rates, and tax planning

Economists studying the significant decreases in corporate tax rate in OECD countries from 1982-1999 estimate that a one percentage-point reduction in the weighted average statutory tax rate in other countries is associated with a 0.7 percentage-point reduction in the home country tax rate.[225] In addition, there has been some theoretical research showing that it may be an optimal strategy for countries to set lower tax rates on mobile income (*e.g.*, foreign-source business income) and higher tax rates on less-mobile income, rather than setting a uniform rate.[226] The shift by developed countries toward regimes exempting foreign-source income may reflect this strategy. In addition, some research on U.S. tax rules finds that tax competition occurs not only with respect to corporate income tax rates but also with respect to other features of the tax system that can affect a corporation's tax liability.[227]

3. U.S. tax changes and spillover effects on other countries

Recent research has simulated how the enactment of Public Law 115-97 may have fiscal spillovers outside the United States. One simulation study finds that the changes may result in average revenue losses of between 1.5 percent and 13.5 percent of the worldwide MNE tax base based on predictions that (1) foreign countries lower their tax rates in response to the U.S. rate reduction, (2) more profit is shifted to the United States, and (3) more investment occurs in the

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[224] Surveys of the literature on international tax competition include George R. Zodrow, "Capital Mobility and Capital Tax Competition," *National Tax Journal*, vol. 63, no. 4, pt. 2, December 2010, pp. 865-902; Michael Keen and Kai A. Konrad, "The Theory of International Tax Competition and Coordination," in Alan Auerbach, Raj Chetty, Martin Feldstein, and Emmanuel Saez (eds.), *Handbook of Public Economics*, vol. 5, Elsevier, 2013; and Michael P. Devereux and Simon Loretz, "What Do We Know about Corporate Tax Competition," *National Tax Journal*, vol. 66, no. 3, September 2013, pp. 745-774.

[225] Michael P. Devereux, Ben Lockwood, and Michele Redoano, "Do Countries Compete over Corporate Tax Rates," *Journal of Public Economics*, vol. 92, nos. 5-6, June 2008, pp. 1210-1235.

[226] See the discussion in George R. Zodrow, "Capital Mobility and Capital Tax Competition," *National Tax Journal*, vol. 63, no. 4, pt. 2, December 2010, pp. 865-902

[227] Rosanne Altshuler and Harry Grubert, "Government and Multinational Corporations in the Race to the Bottom," *Tax Notes*, February 27, 2006, pp. 979-992.

United States .[228] The simulation results are largely driven by the reduction in the U.S. corporate tax rate, and the paper does not make strong predictions about the effect of changes in U.S. international tax rules on the worldwide MNE tax base.

[228] Sebastian Beer, Alexander Klemm, and Thornton Matheson, "Tax Spillovers from U.S. Corporate Income Tax Reform," *IMF Working Papers*, no. 18/166, July 2018.

IV. BACKGROUND DATA

Legislation enacted in 2017 changed corporate tax rates in addition to multiple provisions specific to the U.S. taxation of cross-border activities. These changes were first in effect for tax years starting in 2017. The staff of the Joint Committee ("Joint Committee staff") has reviewed data from 2017 and 2018 tax filings in attempt to ascertain the impact of those changes.

A. Effect of Selected Provisions: GILTI, FDII, and the BEAT

In 2017, the Joint Committee staff estimated that the enactment of the international provisions in Public Law 115-97 would result in a net revenue gain of $324 billion over the period 2018 to 2027.[229] If the one-time section 965 tax on deferred foreign income were excluded from that sum, the remaining international provisions, including the GILTI inclusion, the deduction for FDII and GILTI, the BEAT, and the DRD, would produce on net a revenue loss of approximately $15 billion.[230] The Joint Committee staff has examined preliminary aggregate taxpayer data for tax year 2018 and inspected a full sample of taxpayer returns for tax years 2017 and 2018 to provide some indication of the actual tax effects of the legislation.

Table 1, below, shows the sum of that amount of GILTI deductions, FDII deductions, and BEAT liabilities for 81 large C corporations for tax year 2018.[231] These 81 corporations were selected from a list of 200 C corporations that reported the greatest amount of total income on IRS Form 1120;[232] their earnings make up a quarter of all C corporate earnings for that year and their assets make up over a third of U.S. C corporate assets for that year. These C corporations had $546 billion in worldwide consolidated net income as reported on their financial statements and Schedule M-3.

[229] Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act"* (JCX-67-17), December 2017. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[230] *Ibid*.

[231] Note that not all 81 taxpayers claimed a deduction for GILTI and FDII and incurred a BEAT liability.

[232] For a detailed description of the sample and the methods, see Tim Dowd, Christopher Giosa, and Thomas Willingham, "Corporate Behavioral Responses to the TCJA for Tax Years 2017-2018," *National Tax Journal*, vol. 73, no. 4, December 2020, pp. 1109-1134.

Table 1.–Amount of GILTI Deduction, FDII Deduction, and BEAT Liability for 81 Selected C Corporations, 2018 (Billions of Dollars)

GILTI	$102.1
Tentative GILTI Liability	$13.0
GILTI Foreign Taxes Paid	$11.8
GILTI FTCs	$6.6
GILTI Tax Liability after FTCs	$6.3
Average GILTI Tax Liability after FTCs	$0.13
Sec. 250 Deduction	$78.8
Implied GILTI Deduction	$57.0
Implied FDII Deduction	$21.9
Average FDII Tax Benefit	$0.06
BEAT Liability	$0.07

Sources: Joint Committee staff calculations and examination of Forms 1120, 8992, 8993, and 1118 on returns filed for tax year 2018.

These large C corporations reported approximately $102.1 billion of GILTI and $11.8 billion of GILTI foreign taxes paid. These reported values imply that the average foreign tax rate on GILTI was at least 10.4 percent. These C corporations reported roughly $13 billion of tentative GILTI tax liability, $6.6 billion of GILTI foreign tax credits, and $6.3 billion of GILTI liability after foreign tax credits ("FTCs") reported. The $6.3 billion GILTI liability implies a U.S. residual tax rate on GILTI inclusion of 5.5 percent. Combining the $6.3 billion U.S. liability with the $11.8 billion in foreign taxes paid results in a total tax of $18.1 billion—for an overall tax rate of 16 percent on GILTI. Among taxpayers with a GILTI inclusion in this sample, the average GILTI tax liability was $0.13 billion. For the GILTI/FDII deduction, these large C corporations reported approximately $78.8 billion: the implied GILTI deduction and implied FDII deduction were $57.0 and $21.9 billion, respectively. The average reduction in tax liability resulting from the FDII deduction, for those claiming the deduction in the sample, was approximately $0.06 billion. Finally, the total BEAT liability reported for tax year 2018 was roughly $0.07 billion, indicating that C corporations in the sample paid minimal BEAT relative to their earnings, though they may have paid more tax under other provisions as a result of tax planning to reduce or eliminate BEAT liability.

Table 2, below, shows the number of corporate taxpayers by total asset size that reported GILTI inclusion, a GILTI/FDII deduction, or BEAT liability for tax year 2018. Of the approximately 6.44 million corporate taxpayers who filed a tax return in the Form 1120 series for tax year 2018 fewer than 7,000 reported either GILTI inclusion or GILTI/FDII deductions and only 479 reported a BEAT liability. More than 90 percent of these taxpayers have assets totaling less than $50 million. Among taxpayers reporting GILTI inclusion, 47.9 percent had assets of less than $50 million, and among taxpayers reporting a GILTI/FDII deduction, 52.7 percent had

assets totaling less than $50 million. In contrast, taxpayers reporting a BEAT liability were generally larger, with 72.8 percent of those taxpayers reporting at least $50 million in assets and 42.1 percent reporting at least $1 billion in assets. Unlike the deductions for GILTI and FDII, the BEAT has a gross receipts threshold that excludes smaller taxpayers. Because gross receipts generally correlate with invested assets, this may explain why the share of taxpayers with $1 billion or more in assets is higher for the data reporting BEAT liability versus GILTI and FDII.

Table 2.–Number of Corporate[1] Taxpayers with GILTI Inclusion, GILTI/FDII Deduction, or BEAT Liability by Total Asset Size, 2018

Total Assets	Number of Taxpayers			
	Overall[2]	GILTI Inclusion[3]	GILTI/FDII Deduction	BEAT Liability
Less than $50 Million	6,399,370	3,030	3,271	130
$50 Million to $999 Million	35,439	2,110	1,863	147
$1 Billion or More	7,325	1,185	1,064	202
Total	6,442,134	6,325	6,198	479

Source: IRS Statistics of Income and Joint Committee staff calculations.
[1] For this table only, these corporate taxpayers include entities filing forms 1120, 1120S, 1120-L, 1120-PC, 1120-F, 1120-REIT, and 1120-RIC.
[2] The overall number of corporations includes purely domestic corporations that are unlikely to be affected by the three provisions.
[3] The number of taxpayers by total asset size that filed Form 5471 (i.e., has a foreign entity) are: 18,706 (Less than $50 Million), 5,877 ($50 Million to $999 Million), 2,340 ($1 Billion or More), and 26,293 (Total).

B. Impact of Changes to the Corporate Tax Rate

A major component of Public Law 115-97 was the reduction in the top corporate statutory tax rate from 35 percent to 21 percent. An important motivation was the perceived competitive disadvantage that U.S. corporations had in competing with other MNEs,[233] based on comparison with statutory rates of other OECD countries.

To evaluate how the change in the U.S. corporate tax rate may have affected the tax position of U.S. MNEs around the world, Table 3, below, reports average tax rates[234] for U.S. MNEs based on their operations in (1) the United States, (2) the world as a whole (labeled "WW"),[235] (3) all countries excluding the United States (labeled "Foreign"), (4) the European Union (labeled "E.U."), and (5) the top ten U.S. trading partners.[236] The rates are calculated from Form 8975, Country by Country Report, for years 2017 and 2018.[237] U.S. MNEs with revenues in excess of $850 million are required to file Form 8975 and report their unrelated party revenues, related party revenues, total revenues, profit or loss, income taxes paid on a cash basis, income taxes accrued for the current year, stated capital, accumulated earnings, number of full-time equivalent employees, and tangible assets in each jurisdiction where they are resident. The following tables reflect a subset of taxpayers filing Form 8975, comprising 1,567 taxpayers in 2017 and 1,621 taxpayers in 2018. In creating this sample of taxpayers, Joint Committee staff dropped several dozen taxpayers that filed partial year returns or used outdated forms.

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[233] Committee Recommendations as Submitted to the Committee on the Budget Pursuant to H. Con. Res. 71, S. Prt. 115-20, December 2017, pp. 113-114.

[234] Average tax rates in a specific region are based on taxes paid to all tax jurisdictions by entities located in that region.

[235] Worldwide ("WW") excluding stateless includes the United States and foreign countries and excludes a business entity that does not have a tax jurisdiction of residence, which is considered "stateless." The tax jurisdiction of residence of a permanent establishment is the jurisdiction in which the permanent establishment is located.

[236] The top ten U.S. trading partners were determined based on the sum of goods exports and imports in calendar year 2017. The countries are: Canada, China, France, Germany, Italy, Japan, Korea, Mexico, and the United Kingdom.

[237] Form 8975 is required by Treas. Reg. sec. 1.6038-4 and includes both corporations and partnerships as the ultimate owner. Corporations are approximately 95 percent of the parent owners and report approximately 95 percent of the revenues. There are several important ambiguities to note when interpreting this data. MNEs can and do use a variety of financial reporting standards and can choose whichever one they would like to use for reporting information on Form 8975 (*i.e.*, if these MNEs have different permanent establishments with separate books that differ from the parent corporation). Consequently, what is in the income and tax items will differ across MNEs. Additionally, the rules were not clear on whether to include dividend income in profits, even though it was clear that it should not be included in revenues. As a result, there could be some double counting of dividend income in the profits line. Also, related party revenues are not on a consolidated basis. Rather, they are reported in aggregate. So, related party revenues will have some double counting in jurisdictions. Taxes paid on a cash basis could include taxes owed in a prior year or a refund from a prior year. Finally, taxpayers were instructed to report income, assets, and employees for entities that are pass throughs or transparent for tax purposes in the jurisdiction as stateless. As a result, the Joint Committee staff dropped the stateless category from calculations to avoid double counting of income.

Table 3.–Average[1] and Median[2] Tax Rates for U.S. Multinational Enterprises in Selected Regions

	2017		2018	
	Taxes Paid (percent)	Taxes Accrued (percent)	Taxes Paid (percent)	Taxes Accrued (percent)
U.S. Average Tax Rate	16.0	19.7	7.8	13.1
WW Average Tax Rate, Excluding Stateless	14.2	16.5	8.8	12.1
Median Foreign Tax Rate	15.7	15.8	15.1	16.7
E.U. Average Tax Rate	10.7	11.2	8.7	9.1
E.U. Median Tax Rate	16.6	17.1	13.9	17.5
Top Ten Trading Partners Average Tax Rate	19.2	19.8	18.1	18.0
Top Ten Trading Partners Median Tax Rate	23.1	23.8	22.0	22.4

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018 for subsidiaries and jurisdictions with positive profits before income taxes.
[1] The Average Tax Rate ("ATR") is calculated based on income weighted averages. The ATR is calculated within country for the U.S. and across countries for WW, Foreign, E.U., and the Top Ten Trading Partners.
[2] The Median Tax Rate is calculated based on the median across the weighted countries' ATR.

Table 3 shows the average tax rate paid by U.S. MNEs by region as reported on Form 8975 for tax years 2017 and 2018. These tax rates are calculated by dividing either cash taxes paid or taxes accrued by net profits per financial books for profitable entities. It is worth noting that net profits per financial books is not the same as taxable income (*e.g.*, bonus deprecation would not reduce net profits per financial books for financial reporting purposes but would reduce taxable income). The first row shows that U.S. MNEs reported an average cash tax rate of 16 percent on their domestic net profit (*i.e.*, the 16 percent accounts for only U.S. income taxes paid on U.S. net profit). When taxes accrued for 2017 are included in addition to taxes paid, the average tax rate increases to almost 20 percent. There are many reasons cash taxes paid and accrued taxes may differ. For example, cash taxes paid may include prepayments and refunds of tax related to other taxable years while accrued taxes generally would not.

The reduction in the corporate statutory rate to 21 percent from 35 percent can be seen in the substantial decline in U.S. average tax rates for these MNEs in 2018. That year, these MNEs reported an average tax rate of 7.8 percent on a cash basis and 13.1 percent on an accrued basis. The second row reports the average tax rate these MNEs were subject to on a worldwide basis.[238] Generally, the decline in the U.S. corporate income tax rate in 2018 affected the decline in taxes paid and taxes accrued from 2017 to 2018 and was reflected in declining tax rates on worldwide net profit for these U.S. MNEs. The third row shows the median foreign tax rate reported by U.S. MNEs, which is about 16 percent for both cash taxes paid and accrued taxes. Unsurprisingly, because the reduction in the U.S. corporate income tax rate only applied to

[238] The worldwide calculation reports total income tax on total worldwide income and excludes income and taxes paid if the entity was determined to be stateless. A stateless entity is one that either is transparent to the tax jurisdiction (*e.g.*, a partnership) or does not have a jurisdiction in which it is tax resident.

income taxable in the United States, the table reports minimal change in foreign tax rates for 2018.

The next four lines of Table 3 report the average tax rate and the median tax rate paid and accrued by U.S. MNEs in the E.U. member states and the top ten U.S. trading partners. The average tax rate for U.S. MNEs in the top ten trading partners was approximately twice that of their average tax rate in the E.U. The median tax rate has a similar dispersion, with the median tax rate for U.S. MNEs in the top ten trading partners about six to eight percentage points greater than the median tax rate in the E.U.

Table 4 below reports the ten foreign countries where U.S. MNEs reported the greatest amount of unrelated party revenues for 2017 and 2018. Unrelated party revenues consist of revenue from third party sales that require no transfer pricing. These top ten countries in each of 2017 and 2018 make up 62 percent of total unrelated party revenues reported on Form 8975. The list of countries includes some of the United States's largest trading partners, including the United Kingdom, Canada, China, Germany, Japan, and France. Average tax rates paid on profits in these jurisdictions range from 3.9 percent in Singapore to 22.8 percent in France in 2018.

Table 4.–Top Ten Countries: Unrelated Party Revenues

2017			2018		
Country	**Share of Revenues (percent)**	**Cash ATR (percent)**	**Country**	**Share of Revenues (percent)**	**Cash ATR (percent)**
United Kingdom	12.2	10.6	United Kingdom	12.7	10.6
Canada	9.4	15.9	Canada	8.6	15.1
Ireland	6.1	13.0	Ireland	6.8	11.4
China	6.0	24.2	Singapore	6.0	3.9
Germany	5.5	22.0	China	5.8	21.4
Japan	5.3	20.1	Germany	5.4	21.3
Singapore	5.2	4.5	Japan	5.1	22.6
Switzerland	4.6	5.7	Switzerland	4.6	6.2
France	3.7	35.4	France	3.4	22.8
Brazil	3.7	27.0	Netherlands	3.4	3.9
Total Share in Top Ten	61.5		Total Share in Top Ten	61.6	
Median Cash ATR in Top Ten		18.0	Median Cash ATR in Top Ten		13.2

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction.

Table 5 reports the ten foreign countries[239] where U.S. MNEs reported their greatest related party revenues for 2017 and 2018. There is substantial overlap between the top ten countries for related party revenues with the list of top ten countries for unrelated party revenues.

Table 5.–Top Ten Countries: Related Party Revenues

2017			2018		
Country	**Share of Relative Revenues (percent)**	**Cash ATR (percent)**	**Country**	**Share of Relative Revenues (percent)**	**Cash ATR (percent)**
Singapore	11.4	4.5	Ireland	11.6	11.4
Ireland	9.6	13.0	Singapore	11.2	3.9
Switzerland	9.3	5.7	Switzerland	9.3	6.2
Netherlands	7.6	5.0	Netherlands	8.1	3.9
United Kingdom	6.5	10.6	United Kingdom	5.6	10.6
China	5.4	24.2	China	5.4	21.4
Canada	5.0	15.9	Canada	4.9	15.1
Germany	4.2	22.0	Germany	3.9	21.3
Belgium	3.4	22.6	Belgium	3.2	17.2
Puerto Rico	3.2	1.3	Mexico	3.1	30.4
Total Share in Top Ten	65.6		Total Share in Top Ten	66.2	
Median Cash ATR in Top Ten		11.8	Median Cash ATR in Top Ten		13.2

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction.

[239] Puerto Rico, although a territory of the United States, is here listed as a foreign country. For purposes of country-by-country reporting, a U.S. MNE must report information on related parties operating in another tax jurisdiction, including jurisdictions that have fiscal autonomy even if they are not sovereign. The U.S. territories that are considered to have fiscal autonomy and are therefore tax jurisdictions for the Country by Country Report are Puerto Rico, U.S. Virgin Islands, Guam, American Samoa, and Northern Marianas. See Treas. Reg. sec. 1.6038-4(b)(7) and (10).

Table 6, below, shows the ten foreign countries where U.S. MNEs reported their greatest net profits for 2017 and 2018. U.S. MNEs reported substantial net worldwide profits in these jurisdictions. These countries represented 60 and 64 percent of the total profits reported on Form 8975 for 2017 and 2018, respectively. Several of the countries in lists of the top ten countries for related or unrelated party revenues in each year are included in the top ten list of countries for profits, including Canada and the United Kingdom. However, in contrast to the revenue tables, the top ten countries for profits are dominated by low-tax jurisdictions. The median average cash tax rate for the top ten countries was 5.3 percent in 2017 and 3.9 percent in 2018.

Table 6.–Top Ten Countries: Net Profits

2017			2018		
Country	**Share of Net Profits (percent)**	**Cash ATR (percent)**	**Country**	**Share of Net Profits (percent)**	**Cash ATR (percent)**
Cayman Islands	9.3	0.3	Bermuda	9.9	0.4
Singapore	8.5	4.5	Netherlands	9.1	3.9
Switzerland	7.6	5.7	United Kingdom	8.3	10.6
Netherlands	6.4	5.0	Singapore	8.1	3.9
Puerto Rico	5.4	1.3	Switzerland	5.9	6.2
Bermuda	5.0	2.4	Ireland	5.1	11.4
Canada	4.9	15.9	Cayman Islands	5.0	0.3
Ireland	4.6	13.0	Canada	4.5	15.1
China	4.2	24.2	Puerto Rico	3.9	1.4
Japan	3.9	20.1	Luxembourg	3.8	1.3
Total Share in Top Ten	60.0		Total Share in Top Ten	63.5	
Median Cash ATR in Top Ten		5.3	Median Cash ATR in Top Ten		3.9

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction.

Table 7, below, shows the ten foreign countries where U.S. MNEs reported the greatest amount of tangible assets for 2017 and 2018. The tangible assets reported by U.S. MNEs in these countries represent 61 percent of the foreign tangible assets reported on Form 8975. Similar to the tables on related (11.8 percent in 2017 and 13.2 percent in 2018) and unrelated party revenues (18.0 percent in 2017 and 13.2 percent in 2018), the median average cash tax rate was 14.4 percent in 2017 and 13.2 percent in 2018 across these countries.

Table 7.–Top Ten Countries: Tangible Assets

2017			2018		
Country	**Share of Tangible Assets (percent)**	**Cash ATR (percent)**	**Country**	**Share of Tangible Assets (percent)**	**Cash ATR (percent)**
United Kingdom	18.1	10.6	United Kingdom	18.1	10.6
Luxembourg	9.5	0.7	Luxembourg	8.8	1.3
Canada	8.3	15.9	Canada	8.0	15.1
Australia	4.7	15.7	Australia	4.7	16.9
China	3.9	24.2	Ireland	4.4	11.4
Ireland	3.9	13.0	China	4.2	21.4
Germany	3.4	22.0	Mexico	3.3	30.4
Mexico	3.2	29.7	Germany	3.2	21.3
Netherlands	2.9	5.0	Netherlands	3.1	3.9
Singapore	2.6	4.5	Singapore	2.8	3.9
Total Share in Top Ten	60.5		Total Share in Top Ten	60.6	
Median Cash ATR in Top Ten		14.4	Median Cash ATR in Top Ten		13.2

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction.

Table 8, below, reports the ten foreign countries where U.S. MNEs reported having the greatest full-time equivalent employees in 2017 and 2018. The top ten countries based on the number of employees is dominated by India, China, Mexico, and the United Kingdom. These ten countries make up about two-thirds of the foreign employees reported by these U.S. MNEs on Form 8975. These countries tend to also have higher corporate tax rates relative to, for example, the countries where profits are reported, as evidenced by the median average cash tax rates of 23 and 22 percent for 2017 and 2018, respectively.

Table 8.–Top Ten Countries: Employees

2017			2018		
Country	**Share of Total Employees (percent)**	**Cash ATR (percent)**	**Country**	**Share of Total Employees (percent)**	**Cash ATR (percent)**
India	11.1	34.3	Taiwan	10.4	18.2
China	10.0	24.2	India	10.2	40.3
Mexico	9.3	29.7	Mexico	8.6	30.4
United Kingdom	9.2	10.6	China	8.6	21.4
Canada	7.3	15.9	United Kingdom	8.5	10.6
Germany	4.3	22.0	Canada	6.6	15.1
Brazil	4.3	27.0	Germany	4.0	21.3
Philippines	3.2	21.5	Brazil	3.5	26.1
Japan	3.0	20.1	Philippines	3.2	22.1
France	2.9	35.4	Japan	2.7	22.6
Total Share in Top Ten	64.6		Total Share in Top Ten	66.3	
Median Cash ATR in Top Ten		23.1	Median Cash ATR in Top Ten		21.7

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction.

Tables 4 through 8 present percentage shares of certain economic variables. Table 9, below, shows that the level of those variables (in billions of dollars and thousands for employees)—unrelated party revenue, related party revenue, net profits, tangible investment, and employees—generally grew between 2017 and 2018 both in the United States and outside the United States.

Table 9.–Changes in Reported Revenues, Net Profit, Tangible Assets, and Employees Between 2017 and 2018 (Billions of Dollars, Employees Thousands)

	Unrelated Revenue	Related Revenue	Net Profit	Tangible Assets	No. Employees
United States (Billions of Dollars, and Thousands of Employees)	$817	$333	$380	$348	654
Percentage of 2017 Amount	8.1%	10.5%	34.2%	6.4%	3.0%
Foreign, Excluding Stateless (Billions of Dollars, and Thousands of Employees)	$527	$402	$333	$11	1779
Percentage of 2017 Amount	13.4%	14.1%	52.9%	0.5%	13.8%

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. The sample for this table is restricted to U.S. entities that are observed in both 2017 and 2018.

To facilitate understanding the pattern of economic activity within countries important to the operation of U.S. MNEs, Table 10, below, combines the information contained in Tables 4 through 8 and presents all the share figures and ranks next to each country for 2017. The rank columns report the country in rank order from largest amount of aggregate U.S. MNE revenues (or assets or employees) in the jurisdiction to the smallest amount, with a rank of one indicating the largest. The countries listed in Table 10 include any country that appears in Tables 4 through 8 for 2017, and thus represent countries where U.S. MNEs reported a significant share of related party revenues, unrelated party revenues, net profits, tangible investment, or employees in 2017. Table 11 is constructed similarly and applies to data for 2018.

Table 10.–Compilation Data from Tables Four to Eight by Jurisdiction, 2017

2017	Unrelated Revenues		Related Revenues		Profit/Loss		Tangible Assets		No. Employees		Cash ATR
	Share	Rank	Share	Rank	Share	Rank	Share	Rank	Share	Rank	ATR
AUSTRALIA	3.1	12	0.7	25	2.3	14	4.7	4	2.1	11	15.7
BELGIUM	1.6	16	3.4	9	0.9	23	1.8	15	0.8	25	22.6
BERMUDA	0.3	44	2.3	14	5.0	6	0.5	39	0.0	136	2.4
BRAZIL	3.7	10	1.1	18	0.9	22	2.6	11	4.3	7	27.0
CANADA	9.4	2	5.0	7	4.9	7	8.3	3	7.3	5	15.9
CAYMAN ISLANDS	0.4	37	2.5	13	9.3	1	1.0	21	0.0	112	0.3
CHINA	6.0	4	5.4	6	4.2	9	3.9	5	10.0	2	24.2
FRANCE	3.7	9	2.0	15	0.7	28	2.4	13	2.9	10	35.4
GERMANY	5.5	5	4.2	8	1.0	20	3.4	7	4.3	6	22.0
INDIA	1.5	17	1.5	17	1.9	16	1.3	17	11.1	1	34.3
IRELAND	6.1	3	9.6	2	4.6	8	3.9	6	1.1	20	13.0
JAPAN	5.3	6	0.9	20	3.9	10	1.8	14	3.0	9	20.1
LUXEMBOURG	1.0	21	3.0	12	3.9	11	9.5	2	0.1	64	0.7
MEXICO	3.3	11	3.2	11	2.4	13	3.2	8	9.3	3	29.7
NETHERLANDS	3.1	13	7.6	4	6.4	4	2.9	9	1.2	18	5.0
PHILIPPINES	0.3	45	0.5	31	0.4	44	0.4	45	3.2	8	21.5
PUERTO RICO	0.4	36	3.2	10	5.4	5	0.9	24	0.5	35	1.3
SINGAPORE	5.2	7	11.4	1	8.5	2	2.6	10	1.3	17	4.5
SWITZERLAND	4.6	8	9.3	3	7.6	3	2.5	12	0.6	33	5.7
UNITED KINGDOM	12.2	1	6.5	5	2.9	12	18.1	1	9.2	4	10.6
Total Share Reported For these 20	76.3		83.4		77.3		75.7		72.4		9.9
Total Excluding U.S. and Stateless	4,008		2,876		642		2,338		13,252		11.5

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction. Average tax rate in the total line for the 20 countries is an income weighted average across all of the jurisdictions, as is the average tax rate in the total line excluding the U.S. and Stateless. Total excluding U.S. and stateless is in billions for income items and thousands for employees.

Table 11.–Compilation Data from Tables Four to Eight by Jurisdiction 2018

2018	Unrelated Revenues		Related Revenues		Profit/Loss		Tangible Assets		No. Employees		Cash ATR
	Share	Rank	Share	Rank	Share	Rank	Share	Rank	Share	Rank	ATR
AUSTRALIA	3.3	11	0.8	23	2.0	15	4.7	4	2.0	12	16.9
BELGIUM	1.6	16	3.2	9	1.0	22	2.0	15	0.7	27	17.2
BERMUDA	0.4	38	2.9	12	9.9	1	0.8	27	0.0	130	0.4
BRAZIL	3.1	13	1.0	18	0.4	32	2.4	12	3.5	8	26.1
CANADA	8.6	2	4.9	7	4.5	8	8.0	3	6.6	6	15.1
CAYMAN ISLANDS	0.3	39	1.7	16	5.0	7	0.5	38	0.0	78	0.3
CHINA	5.8	5	5.4	6	3.4	11	4.2	6	8.6	4	21.4
FRANCE	3.4	9	2.1	14	0.4	33	2.3	13	2.5	11	22.8
GERMANY	5.4	6	3.9	8	1.6	18	3.2	8	4.0	7	21.3
INDIA	1.5	17	1.5	17	1.1	21	1.4	16	10.2	2	40.3
IRELAND	6.8	3	11.6	1	5.1	6	4.4	5	1.0	21	11.4
JAPAN	5.1	7	0.9	20	3.0	12	2.0	14	2.7	10	22.6
LUXEMBOURG	0.8	23	2.8	13	3.8	10	8.8	2	0.1	63	1.3
MEXICO	3.2	12	3.1	10	1.8	17	3.3	7	8.6	3	30.4
NETHERLANDS	3.4	10	8.1	4	9.1	2	3.1	9	1.1	18	3.9
PHILIPPINES	0.3	42	0.4	34	0.3	43	0.4	43	3.2	9	22.1
PUERTO RICO	0.4	36	2.9	11	3.9	9	1.0	21	0.5	34	1.4
SINGAPORE	6.0	4	11.2	2	8.1	4	2.8	10	1.1	17	3.9
SWITZERLAND	4.6	8	9.3	3	5.9	5	2.6	11	0.5	33	6.2
TAIWAN	0.8	24	0.6	29	0.4	37	0.9	25	10.4	1	18.2
UNITED KINGDOM	12.7	1	5.6	5	8.3	3	18.1	1	8.5	5	10.6
Total Share Reported For these 21	73.9		83.0		78.9		72.3		73.9		8.9
Total Excluding U.S. and Stateless	4,538		3,299		971		2,356		15,088		10.3

Note: Joint Committee staff calculations of Form 8975 for the years 2017 and 2018. Share calculations are for both profitable and loss subsidiaries and jurisdictions. Average tax rates for cash taxes paid are calculated as the average across all subsidiaries with positive profits before income taxes in each jurisdiction. Average tax rate in the total line for the 21 countries is an income weighted average across all of the jurisdictions, as is the average tax rate in the total line exlcuding the U.S. and Stateless is in billions for income items and thousands for employees.