Budget Model

Effective Tax Rates on U.S. Multinationals' Foreign Income under Proposed Changes by House Ways and Means and the OECD

Summary: The House Ways and Means Committee reforms proposed as part of budget reconciliation would more than triple the U.S. tax rate on multinationals' foreign income and produce a higher rate than a proposed global agreement currently being negotiated through the OECD.

Key Points

- The Tax Cuts and Jobs Act of 2017 (TCJA) taxation of multinationals' foreign income maintained a similar overall tax burden: both before and after TCJA, multinationals paid an effective U.S. tax rate of around 2 percent on their foreign income.

- The House Ways and Means Committee reforms proposed as part of budget reconciliation would more than triple the U.S. tax rate on multinationals' foreign income, from around 2.1 percent to 7.4 percent, averaged by foreign income across industries. If the U.S. instead adopted the draft OECD proposal, U.S. multinationals would pay a residual U.S. tax rate of 6.1 percent.

- The future competitiveness of U.S. multinational firms depends critically on whether other OECD countries also increased their tax rates.

Introduction

Effective tax rates (ETRs) reflect the amount of tax paid on a dollar of income, accounting for tax credits, differences between actual income and taxable income, and other factors that cause the true tax burden to differ from the statutory tax rate.[1]

Prior to passage of TCJA in 2017, all foreign income was notionally subject to tax at the statutory rate of 35% as it was earned. But foreign income was generally not recognized for U.S. tax purposes unless paid out as a dividend

to U.S. taxpayers (repatriated), and multinationals could defer U.S. taxes on most foreign income indefinitely by retaining it in foreign affiliates. Under this system, multinationals could minimize or eliminate their U.S. tax liability through judicious timing of repatriations. In aggregate, PWBM estimates that multinationals paid ETRs (excluding Subpart F income) between 1.4% and 2.8%, or less than one tenth of the statutory rate of 35%.

The option to defer taxation indefinitely, combined with the expectation of eventual tax "holidays" on foreign income, led to the accumulation of substantial amounts of un-repatriated income abroad. Though nominally controlled by foreign affiliates, this income was typically deposited in U.S. banks or invested in U.S. assets. Major multinationals could generally access this income through the financial system and use it as though it had been repatriated, including to pay dividends or finance domestic investment. Less financially sophisticated firms, however, faced a choice between paying the statutory rate of 35%, holding a stock of accumulated earnings abroad, or reinvesting such earnings in their foreign operations. In all cases, the tax planning incentives created by deferral resulted in additional complexity and cost.

The pre-TCJA international tax regime is commonly referred to as a worldwide system because foreign income was notionally subject to tax as it was earned. In practice, recognition of most foreign income was deferred with no tax paid, resulting in what was effectively a territorial system for most major multinationals.

After TCJA

The regime introduced by TCJA is generally commonly to as a territorial system because most foreign income is exempt from tax upon repatriation. However, some foreign income is taxed as it is earned, with no option of deferral. While this income is taxed at a preferential rate, mandatory current inclusion of foreign affiliates' income in U.S. parents' taxable income results in what is effectively a worldwide system for many multinationals. According to a former House senior tax counsel who played a leading role in the development of TCJA, "Most U.S. [multinationals] believe we moved the system closer to pure worldwide even if we messaged it as moving closer to territorial."

TCJA introduced a minimum tax on multinationals' foreign income through the Global Intangible Low-Taxed Income (GILTI) regime. Taxes on GILTI are determined on an aggregate basis, based on a taxpayer's consolidated global operations. Income from profitable foreign affiliates can be offset by losses from other affiliates, and tax credits from high-tax affiliates can be used to offset liability arising from low-tax affiliates.

This *aggregate* determination of tax liability is consistent with a multinational operating in multiple countries for business reasons – for example, a manufacturing facility in a low-cost country and a sales office in a market country. However, aggregate determination also allows a multinational to benefit from shifting income to tax havens, as foreign taxes paid in high-tax jurisdictions can be used as a credit against U.S. residual tax on tax haven income.

Proposed Changes by U.S. House and OECD

The U.S. is currently the only OECD country that imposes a minimum tax on the foreign income of its multinationals. A recent proposal from the House Ways and Means Committee would magnify this difference, increasing the tax burden on U.S. corporations' foreign income to finance increased spending and cuts in other

taxes as part of a budget reconciliation package. However, ongoing negotiations through the OECD/G20 Inclusive Framework on BEPS would – if successful – lead to the adoption of a global minimum tax by more than 130 countries, including the home countries of nearly every major foreign multinational.

Both the recent Congressional proposal and the proposed global minimum tax under negotiation through OECD would shift the determination of taxes on foreign income from an aggregate basis to a country-by-country basis. Instead of treating a multinational as single global entity with components in various jurisdictions, its activities in each country would be treated as independent operations. Minimum tax would be imposed separately for each country rather than on a consolidated basis. Under country-by-country determination, tax haven income is taxed at the minimum rate regardless of taxes paid elsewhere.

Table 1 presents estimated ETRs in 2022 and other information under alternative international tax regimes: current law, the pre-TCJA regime, and three proposed reforms that would raise revenue. Row 1 shows the rate of residual tax imposed by the U.S. on foreign income, on top of taxes already paid to foreign governments. Row 2 shows the total ETR, including both U.S. and foreign taxes. Row 3 shows the projected 10-year change in revenue for the three proposed alternatives. Rows 4 to 15 detail the parameters of each international tax regime. These projections are preliminary as they are based on current information available for House and OECD proposals; we will update these estimates as new details.

Table 1: Estimated 2022 ETRs Under Alternative International Tax Regimes

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		Current law	**Pre-TCJA equivalent***	**House proposal**	**House proposal without country-by-country**	**OECD Pillar 2**
1	Residual US ETR on MNEs' foreign income	2.1%	1.4 - 2.8%	7.4%	5.1%	6.1%
2	Combined US and foreign ETR on MNEs' foreign income	12.7%	12 - 13.4%	18%	15.7%	16.7%
3	Revenue, 2022-2031, changes to GILTI and FDII (billions)	-	-	256	107	144
4	Corporate tax rate	21%	35%	26.5%	26.5%	26.5%
5	GILTI deduction	50%	Deferral	37.5%	37.5%	43.4%
6	FTC haircut	20%	0%	5%	20%	0%
7	*GILTI effective statutory tax rate*	*10.5 - 13.125%*	*35%*	*16.6 - 17.4%*	*16.6 - 20.7%*	*15%*

		Current law	Pre-TCJA equivalent*	House proposal	House proposal without country-by-country	OECD Pillar 2
8	Deduction for return on tangible assets	10%	0%	5%	5%	7.5%
9	Deduction for return on labor	0%	0%	0%	0%	7.5%
10	Country-by-Country	No	No	Yes	No	Yes
11	NOL carryforwards	No	No	Yes	No	Yes
12	FTC carryforwards	No	Yes	Yes	No	Yes
13	Include FOGEI in GILTI	No	Yes	Yes	Yes	Yes
14	FDII deduction	37.5%	0%	21.875%	21.875%	37.5%
15	*FDII effective statutory tax rate*	*13.125%*	*35%*	*20.7%*	*20.7%*	*16.6%*

Source: PWBM
Notes: Foreign income includes all income of foreign affiliates except Subpart F income.
ETR = effective tax rate; MNE = multinational enterprise.
* Pre–TCJA policy is mapped to approximate post–TCJA–equivalent concepts. ETRs reflect U.S. residual tax paid in a given year on all foreign income (except Subpart F income) and are given as a range to reflect annual variability in the timing of repatriations.

The proposed reforms would lead to substantially higher minimum ETRs than the current GILTI regime. The House proposal would impose a country-by-country minimum tax of between 16.6 and 17.4 percent. PWBM estimates that if this proposal were adopted, the residual U.S. tax rate on multinationals' foreign income would rise from 2 percent under current law to 7.4 percent.

The draft OECD proposal would impose a country-by-country minimum tax of 15 percent. PWBM estimates that if the U.S. were to conform its minimum tax to the OECD proposal, the residual U.S. tax rate on multinationals' foreign income would rise from 2 percent under current law to 6.1 percent.

Figures 1, 2, and 3 report estimated country-level ETRs in 2022 for major foreign jurisdictions where U.S. multinationals report income, for current law and the alternative tax regimes. Because U.S. taxes are assessed at the group level and a multinational group may operate in multiple countries, U.S. tax liability is not directly attributable to specific countries. The plotted ETRs reflect an estimate of the additional tax resulting from scaling up global operations such that net income is $1 higher, holding all else constant.

Figure 1 shows ETRs for the recent House Ways and Means proposal. Figure 2 reports an alternative which retains all elements of the Ways and Means proposal except the shift to country-by-country. Country-by-country determination effectively eliminates any benefit of reporting income in a low-tax country. Under aggregate determination, such benefits are reduced but not eliminated.

Figure 1: Effective tax rates on foreign income, Current law vs. House proposal

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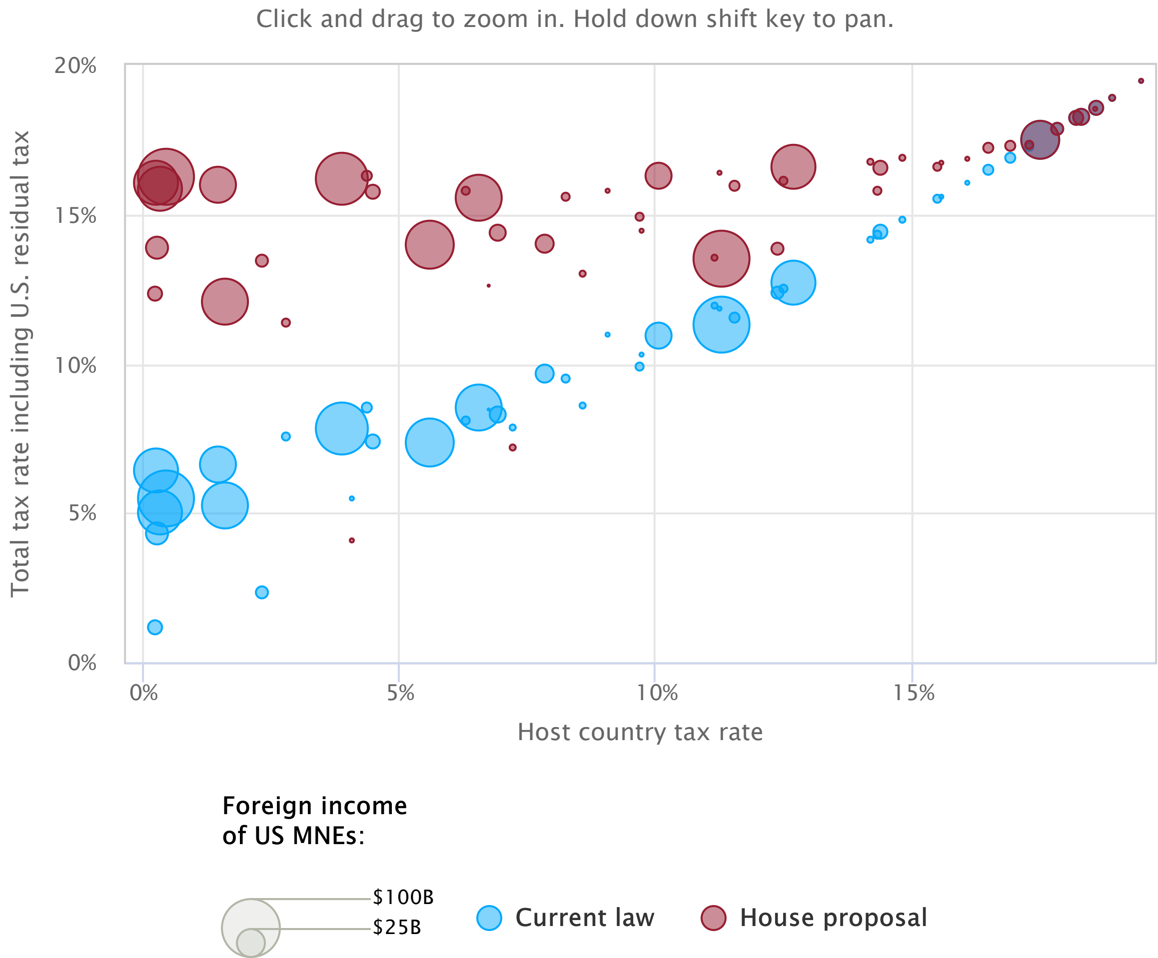

Note: Foreign income includes all income of foreign affiliates except Subpart F income.

Figure 2: Effective tax rates on foreign income, Current law vs. House proposal without country-by-country

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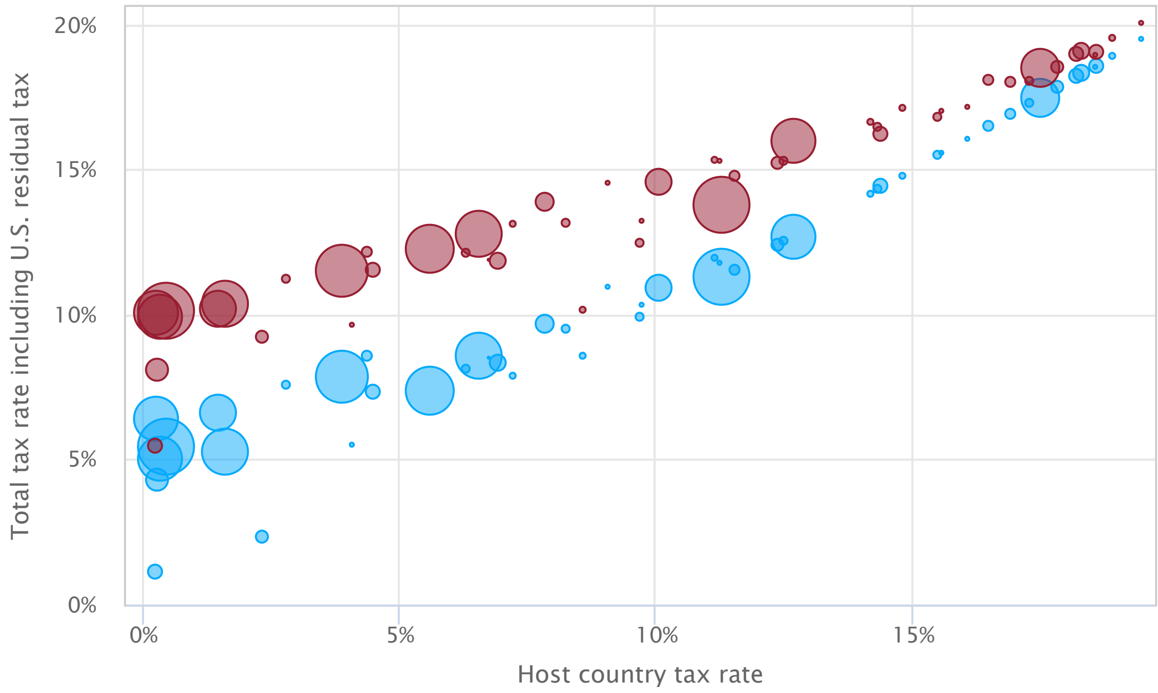
Click and drag to zoom in. Hold down shift key to pan.



Foreign income of US MNEs:

Current law   House proposal ex. country-by-country

Note: Foreign income includes all income of foreign affiliates except Subpart F income.

Figure 3: Effective tax rates on foreign income, Current law vs. OECD Pillar 2

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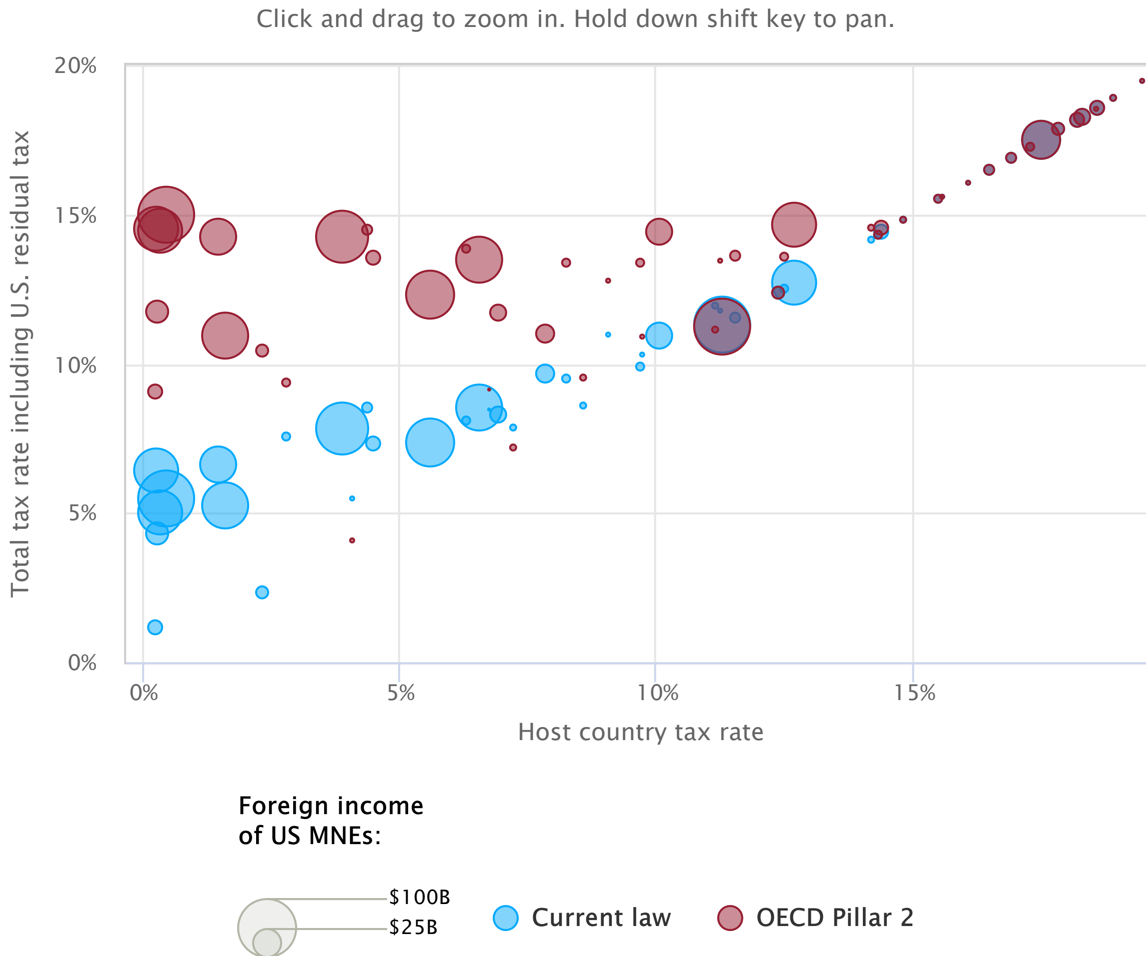

Note: Foreign income includes all income of foreign affiliates except Subpart F income.

Competitiveness

The U.S. House Ways and Means proposal as part of budget reconciliation would more than triple the U.S. tax rate on multinationals' foreign income, from around 2.1 percent to 7.4 percent, averaged by foreign income across industries. The House proposal would tax U.S. multinationals at a higher rate than the proposed global agreement currently being negotiated through the OECD. If the U.S. instead adopted the draft OECD proposal, U.S. multinationals would pay a residual U.S. tax rate of 6.1%.

The future competitiveness of U.S. firms depends on whether other countries adopt the OECD proposal.

- **Case 1 -- U.S. status quo / OECD status quo:** If neither the U.S. nor OECD countries changed their tax regimes, U.S. companies would continue to face a small disadvantage, as under current law.
- **Case 2 -- U.S. status quo / OECD adopts OECD proposal:** If the U.S. retained its current minimum tax regime while other countries adopted the OECD proposal, U.S. multinationals would gain an advantage in

terms of competitiveness and relative profitability, compared with a small disadvantage under current law.

- **Case 3 -- U.S. adopts House / OECD adopts OECD proposal:** If the U.S. adopted reforms recently proposed by the House Ways and Means Committee while OECD countries adopted the OECD proposal, U.S. multinationals would face a generally level playing field, albeit a small disadvantage similar to current law discussed in Case 1.
- **Case 4 -- U.S. adopts House / OECD status quo:** If the U.S. substantially adopts the House proposal, but OECD countries maintain status quo, U.S. multinationals would face a meaningful competitive disadvantage. Notably, foreign multinationals could continue to exploit tax havens to increase their profitability, while U.S. multinationals would not be able to take full advantage of such tax planning opportunities.

Students of economics will quickly recognize these potential “payoffs” as being consistent with the classic Prisoner’s Dilemma game from the field of game theory. In that setting, Case 1 is the “dominant strategy equilibrium” if the game is played only once. However, Case 4 can emerge if the game is (i) repeated many times and (ii) international sanctions are created to punish countries that “cheat” by lowering their tax rate. However, Case 4 also requires substantial cooperation across many countries, including from traditional tax havens like Ireland that have not yet agreed to the OECD proposal.

This analysis was conducted by Alexander Arnon and Zheli He. Prepared for the website by Mariko Paulson.

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1. We calculate the ETR on foreign income as the ratio of income taxes paid or accrued to foreign financial (book) income. Taxes paid or accrued include both foreign and U.S. taxes, except taxes on Subpart F income. Foreign income includes all income earned by U.S. multinationals outside of the U.S., except Subpart F income. We exclude Subpart F income because it is treated separately from other foreign income and is generally taxed as though it were domestic income. ↩