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Budget Model

Did Tax Cuts and Jobs Act of 2017 Increase Revenue on US Corporations' Foreign Income?

Summary: Despite a complete overhaul of the US system of international corporate taxation in the Tax Cuts and Jobs Act of 2017, taxes on US corporations' foreign income are about the same after the law's enactment as before.

Key Points

- The Tax Cuts and Jobs Act of 2017 (TCJA) overhauled the taxation of multinational corporations' foreign income. We examine the impact on firm behavior and government revenue using data recently released by the Internal Revenue Service.
- Despite the move to a participation exemption system in which most dividends from foreign affiliates are not taxed, dividend payments to US parent corporations have fallen by half compared to the years before TCJA's enactment. Notably, the decline of more than $50 billion began in 2017, before the law's changes had gone into effect, likely reflecting multinationals anticipating the tax law change.
- Nearly five years after the law's enactment, there is still significant uncertainty about the impact of the TCJA, including taxes paid by multinationals on their foreign profits.

Background

US corporations with significant overseas activities typically manage these operations through affiliated companies incorporated in a foreign country. These may be wholly owned subsidiaries of a single US parent corporation, partly owned joint ventures with other US businesses or with foreign businesses, or simply an investment in an existing foreign business.[1] The profits earned by these foreign affiliates are subject to taxation in their country of incorporation but may also be taxed by the US. The US provides a foreign tax credit for taxes paid in the country of incorporation to avoid double taxation of the same income.

Prior to the passage of TCJA in 2017, profits of US corporations' foreign affiliates were generally subject to taxation by the US only if they were "repatriated" in the form of a dividend payment from the foreign affiliate to the US parent. Under this system, US multinationals could defer taxes on foreign profits by holding them abroad instead of repatriating them or by using discretion over the timing of dividend payments as a tax planning tool.

TCJA overhauled the taxation of foreign affiliates, ending the deferral system and replacing it with an array of new tax provisions:

- *Participation exemption system*: Under this new system, most dividends received by US multinationals from their foreign affiliates (i.e., repatriated) are not taxed by the US.[2]
- *Section 965 transition tax*: As part of the transition to a participation exemption system, the US levied a one-time tax on past foreign earnings that were never repatriated and were instead accumulated abroad. The tax rates applied to these accumulated profits were substantially lower than the statutory corporate tax rate that applies to other income. The tax may be paid in installments over the eight years following TCJA.
- *Global Intangible Low Taxed Income (GILTI)*: The GILTI regime treats a portion of foreign affiliate income (usually referred to as “GILTI” or “GILTI income”) as though it were earned directly by the US parent corporation. This income is subject to US taxes regardless of whether the income has been repatriated. However, 50 percent of it is exempted from tax, resulting in a special reduced tax rate.[3] Foreign tax credits can offset taxes paid to foreign governments on affiliates’ income, but with a 20 percent “haircut,” meaning that only 80 percent of foreign taxes are offset. In effect, the GILTI regime imposes a minimum tax rate on US multinationals’ foreign profits, accounting for both foreign and US taxes. If US multinationals’ foreign profits were taxed too little by foreign governments, the US levies a “top up tax” to bring the total tax rate up to the minimum.
- *Base Erosion and Anti-Abuse Tax (BEAT)*: BEAT is a special tax levied on large multinationals that try to shift profits from the US to their foreign affiliates facing a lower tax rate than the US parent corporation. Although not directly a tax on foreign affiliate income, BEAT targets the allocation of profits between them and the US parent corporation, which determines how much of a multinational’s income is treated as foreign.
- *Reduced corporate tax rate*: The statutory corporate tax rate, which applies to taxable foreign and domestic income, was lowered from 35 percent to 21 percent.
- *Foreign-Derived Intangible Income (FDII)*: This provision changed the treatment of income earned abroad directly by US corporations rather than through a foreign affiliate corporation. FDII is intended as a complement to the GILTI regime. US corporations that sell directly to foreigners can deduct 37.5 percent of a portion of those profits from their US taxable income, effectively lowering the tax rate on some kinds of export income. The FDII deduction is discussed in more detail below.

Taxes on Foreign Affiliate Income Before and After TCJA

Despite TCJA’s complete transformation of the US approach to taxing foreign affiliate income, the amount of tax owed on US multinationals’ current foreign profits has been remarkably stable.

Figure 1 shows PWBM's estimate of corporate tax liability attributable to income from affiliated foreign corporations, with and without the Section 965 transition tax.[4] While taxes on foreign profits rose nearly $30 billion in 2017 and have remained higher than before TCJA, this increase is almost entirely due to the one-time Section 965 transition tax, the first installment payment of which was due in 2017. The net impact of all the permanent changes, which went into effect beginning in 2018, is shown by the light blue dashed line in Figure 1. In both 2016 and 2018 (before and after the TCJA's changes), US corporations owed about $29 billion in tax on their foreign affiliate income. That rose to $34 billion in 2019 and then fell to $25 billion in 2020, likely because of the pandemic-driven decline in global economic activity.

Figure 1. US Tax Liability on Income from Foreign Affiliates

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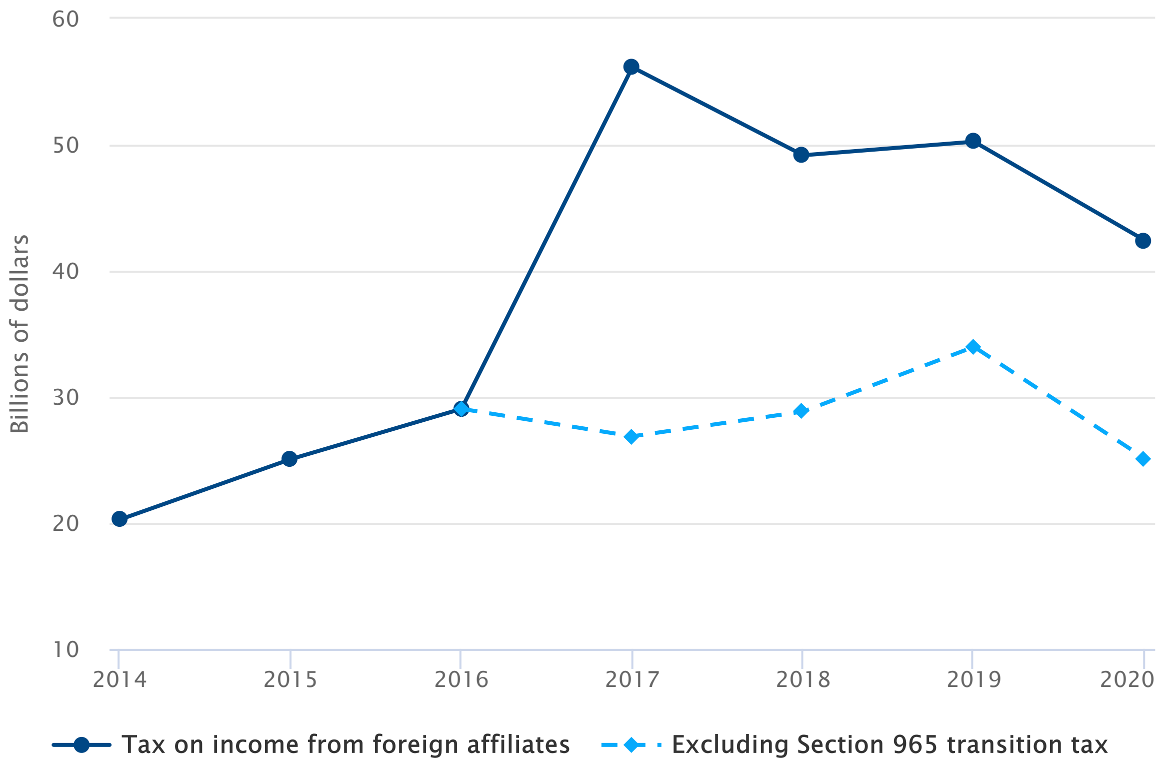

Note: These estimates reflect the addition to corporations' total tax liability from taxes on their foreign income before accounting for interactions between these taxes and other elements of the tax code. This may differ from the amount of additional tax paid. For example, taxable income from foreign affiliates may be offset by a corporation's domestic losses or by net operating loss deduction carryovers.
Source: PWBM estimates based on IRS *Statistics of Income* data from Form 1120 Schedule C, Form 8991, Form 8993, Form 965, and Form 1118.

The stability of taxes on foreign income (excluding the Section 965 transition tax) masks significant but offsetting changes in how affiliate's profits are taxed. So, Figure 2 breaks down the total tax liability from Figure 1 into four components.

Regular income tax, which is the amount of foreign income subject to tax (gross foreign income less deductions) multiplied by the corporate tax rate, fell around $30 billion in 2017 and remained there once the law's major provisions went into effect in 2018. The decline in regular income tax in the year before the law was implemented is discussed in the next section.

The Section 965 transition tax added about $30 billion to taxes paid in 2017 and between $15 and $20 billion over 2018 to 2020.

BEAT has raised only around $2 billion per year since 2018, despite an increase in the statutory penalty for engaging in shifting activities targeted by the tax over that period. Multinationals have responded to BEAT by moving away from the types of transactions targeted by the tax.[5]

The Foreign Tax Credit, which reduces US tax liability when corporations have already paid foreign taxes on the same income, fell around $30 billion in 2017 and in subsequent years. Like regular income tax, this decline began before most of the credit provisions went into effect.

Figure 2. Components of US Tax Liability on Income From Foreign Affiliates

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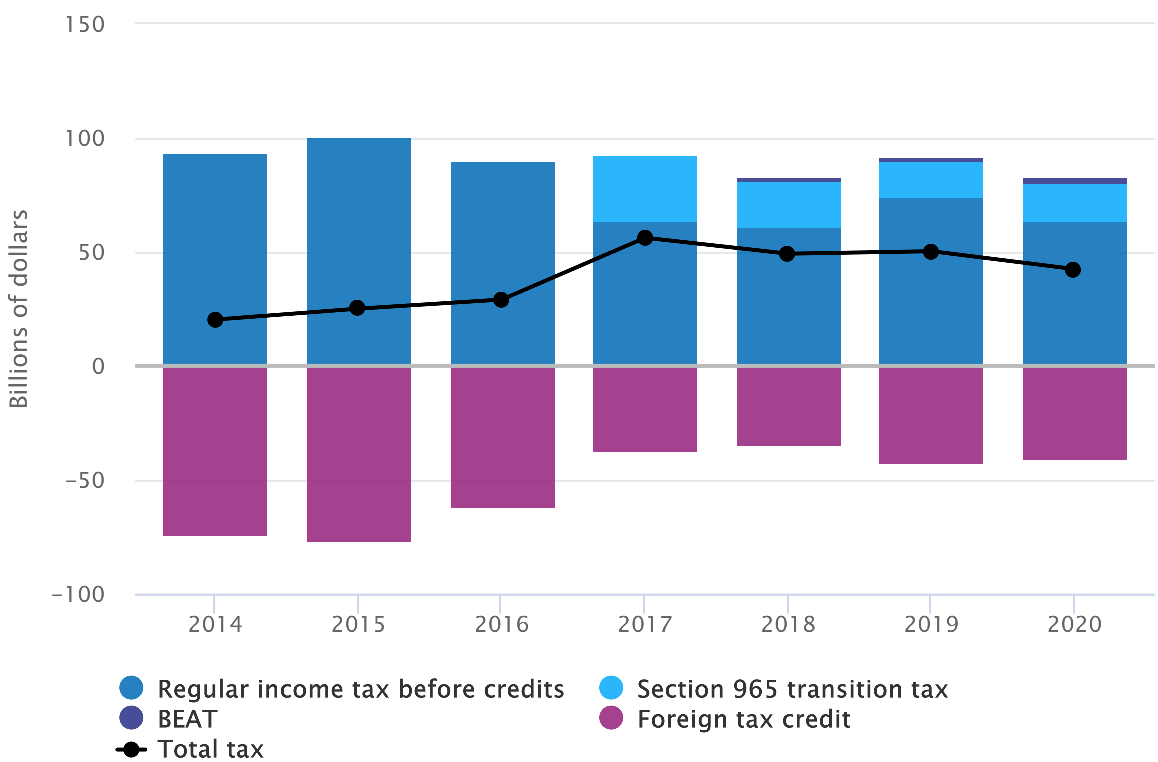

Notes: See note to Figure 1.
Estimates of regular income tax and the Foreign Tax Credit exclude effects related to the Section 965 transition tax.
Source: PWBM estimates based on IRS *Statistics of Income* data from Form 1120 Schedule C, Form 8991, Form 8993, Form 965, and Form 1118.

More Foreign Income is Reported, but Most is Not Taxed

The introduction of the participation exemption system and the GILTI regime has dramatically altered the amount and composition of foreign income reported on US corporations' tax returns. Figure 3 shows the amount of income from foreign affiliate reported on US corporate tax returns either as dividends actually received or as "deemed" income from foreign affiliate corporations. Deemed income is not paid as an explicit dividend to the US parent corporation but is treated as though it had been for tax purposes, similar to the tax treatment of reinvested dividends that is standard with mutual fund investments.

Figure 3. Foreign Affiliate Income Reported by US Corporations

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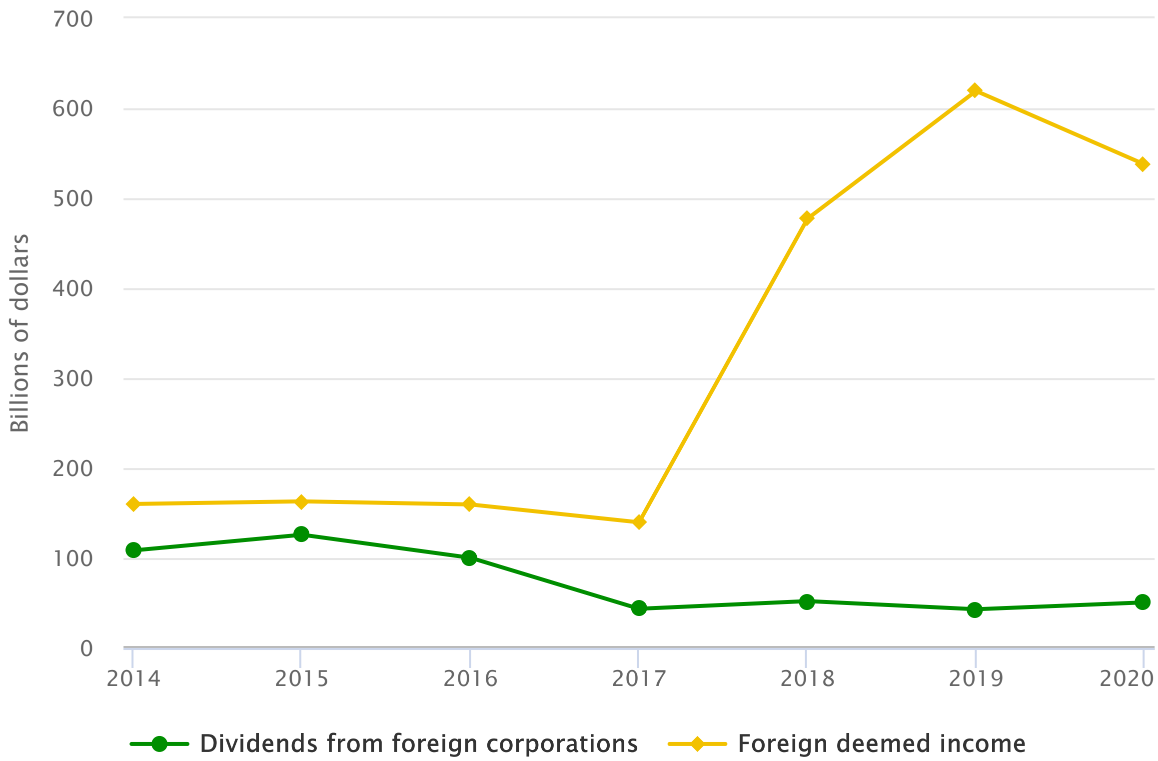

Note: Foreign deemed income excludes inclusions related to the Section 965 transition tax.
Source: PWBM estimates based on IRS *Statistics of Income* data from Form 1120 Schedule C, Form 8993, Form 965, and Form 1118.

Despite the move to a participation exemption system in which most dividends from foreign affiliates are not taxed, dividend payments to US parent corporations have fallen by half compared to the years before TCJA's enactment. Notably, the decline of more than $50 billion began in 2017, before the law's changes had gone into effect. This decline is likely a result of anticipatory behavior by multinationals, who reduced dividend payments in 2017 (when they would have been taxed at the full statutory rate of 35 percent) in expectation of the much lower rates offered by the Section 965 transition tax. Anticipation is the main reason regular income tax on foreign income and the Foreign Tax Credit fell sharply in 2017, as shown in Figure 2.

Once TCJA's major provisions went into effect in 2018, the amount of foreign deemed income reported on corporate returns jumped more than $300 billion, an increase of about 340 percent. This sharp rise in deemed income is a result of the introduction of the GILTI regime, which requires that multinationals recognize much of their foreign affiliates' profits as their own income. US corporations reported $340 billion in GILTI in 2018, almost $500 billion in 2019, and around $440 billion in 2020.

However, the surge in foreign income reported by US corporations did not lead to a corresponding rise in the amount of foreign income subject to tax. Most importantly, taxpayers may deduct 50 percent of their GILTI from taxable income. The introduction of the participation exemption system also means that dividends received – which were taxed at the full 35 percent corporate tax rate prior to TCJA – are no longer taxed at all.

Figure 4 shows taxable income attributable to foreign affiliates, broken out by type of income. While the composition of taxable income is significantly different after TCJA, the total amount is only somewhat higher. Before TCJA, dividends were the largest component; after TCJA, only a few billion dollars of foreign dividends are taxed. GILTI is now the largest component by far, adding between $150 and $225 to US corporations' taxable income between 2018 and 2020.

Figure 4. Components of Taxable Income from Foreign Affiliates

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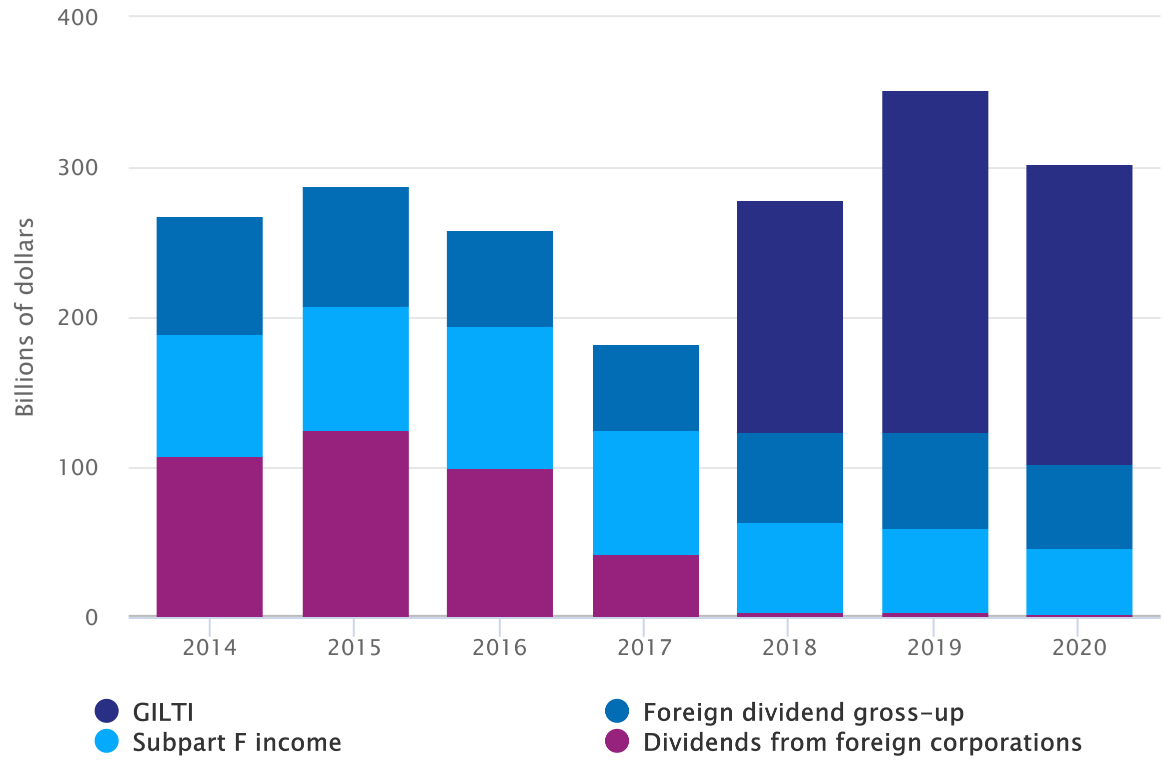

Note: Estimates of foreign dividend gross-up exclude effects related to the Section 965 transition tax.
Source: PWBM estimates based on IRS *Statistics of Income* data from Form 1120 Schedule C, Form 8993, Form 965, and Form 1118.

The Impact of FDII

The deduction for FDII does not relate directly to the taxation of foreign affiliates, since it applies to income earned directly by US corporations. However, it was enacted in TCJA as part of the broader overhaul of international taxes, and FDII is widely viewed as a complement to GILTI. US corporations claimed $53 billion in FDII deductions in 2018, $65 billion in 2019, and $71 billion in 2020.

Figure 5 shows the impact of adding the effects of these deductions to the estimates in Figure 1. FDII offsets much of the post-TCJA tax on income foreign affiliates, leading to a total tax of around $15 billion in 2018 and 2019 and just under $7 billion in 2020.

Figure 5. US Tax Liability on Income from Foreign Affiliates After Including the FDII Deduction

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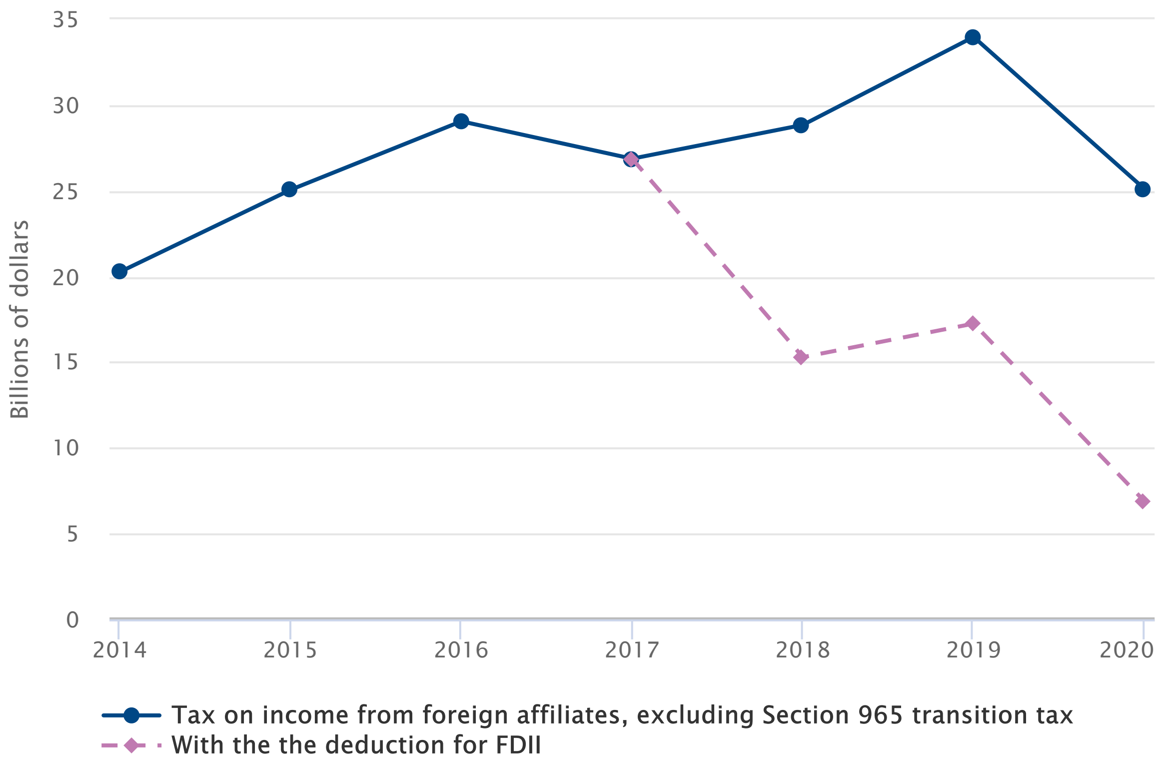

Note: See the note to Figure 1.
Source: PWBM estimates based on IRS *Statistics of Income* data from Form 1120 Schedule C, Form 8991, Form 8993, Form 965, and Form 1118.

This analysis was produced by Alex Arnon. Mariko Paulson prepared the brief for the website.

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1. A foreign corporation that is at least 50 percent owned by US shareholders is called a Controlled Foreign Corporation (CFC). The vast majority of US corporations' investments in foreign affiliates are in CFCs, but

the estimates presented in this brief include any foreign corporation with US corporate shareholders. ↩

2. Specifically, dividends from CFCs are eligible for a 100% deduction. ↩
3. This percentage is scheduled to fall to 37.5% in 2026. ↩
4. See the note to Figure 1 for more information on how to interpret these estimates. ↩
5. See Joint Committee on Taxation, "Background and Analysis of the Taxation of Income Earned by Multinational Enterprises," (July 2023). https://www.jct.gov/publications/2023/jcx-35r-23/ ↩