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International Tax Reform Proposals Would Limit Overseas Profit Shifting, End "Race to the Bottom"

By Samantha Jacoby

Policymakers have an opportunity this year to enact critically important tax reforms that would better prevent multinational corporations from shifting their profits offshore to avoid paying taxes and would raise substantial revenue. They can do so by enacting crucial changes to the 2017 tax law's international framework that the House passed last year as part of its reconciliation package. Those changes would strengthen the law's minimum tax on Global Intangible Low-Taxed Income (GILTI) and the base erosion and anti-abuse tax (BEAT) by broadening the scope of the taxes and raising the applicable tax rates, which would more robustly deter profit shifting. Importantly, the House bill would apply GILTI on a country-by-country basis instead of an aggregate global basis, preventing multinational corporations from avoiding the tax by "blending" their taxes and income in low- and high-tax countries. As the legislation moves forward, this feature of the House-passed bill should be a top priority.

These changes to GILTI and BEAT would help address major flaws of the 2017 tax law, which left significant room for multinational corporations to avoid U.S. taxes by shifting their profits to tax havens (countries that impose little or no tax). The amount of profit shifting by U.S. multinationals has changed little since the 2017 law's enactment, though the law included several measures aimed at preventing this.

These and other much-needed international tax reforms in the House bill would raise around $250 billion over ten years, according to the Joint Committee on Taxation (JCT). Much of this revenue would result from U.S. multinationals paying higher tax rates on their foreign profits; another portion would result from increasing tax penalties on foreign-based multinationals that strip profits out of the U.S. tax base and "book" them (that is, record them on financial statements) in tax havens. Limiting the ability of large multinational corporations to lower their taxes by engaging in cross-border tax avoidance would also help other U.S. businesses compete, such as small and medium-sized businesses that don't operate overseas.

It's especially important for U.S. policymakers to act now because these reforms would more closely align our tax laws with the recent multilateral agreement to modernize the international tax system. The Biden Administration has strongly pushed for this agreement, which more than 130 countries agreed to last fall. Once implemented, it will establish a global minimum corporate tax that ensures large multinationals are taxed at a 15 percent rate in each country in which they operate, largely eliminating the tax benefits of shifting profits to tax havens.

But first, individual governments must implement the deal's terms — and U.S. action would likely push other countries to do so. That's because the global minimum tax and complementary provisions would enable implementing countries to collect additional tax on companies that book profits in low-tax countries, giving those low-tax countries an incentive to adopt the minimum taxes themselves to avoid losing out on revenue that would otherwise go to other countries.

If the U.S. fails to act, some U.S.-based multinationals could face taxation by foreign governments as they begin to implement the deal, with the U.S. forgoing this substantial revenue. In other words, without U.S. action, some U.S. companies might pay increased taxes on part of their income but those increased taxes would go to other countries rather than to fund essential government programs here. The Senate should act quickly to include these key international tax reforms in its own reconciliation bill.

Global Profit Shifting, Corporate Rate Cuts Cost Significant Revenue

Multinational corporations can use various strategies to avoid tax on large amounts of their income by shifting profits to tax havens without changing the location of their investments or operations. One such strategy takes advantage of "transfer pricing" rules, which govern the exchange of goods and services among pieces of the same company. A U.S.-based multinational could transfer (at a low price) intellectual property such as a patent to a subsidiary in a tax haven, then pay the subsidiary royalties (set at a high level) for the right to use the intellectual property worldwide. The subsidiary would record profits on the royalty payments in the tax haven, where they would face little or no tax, and the U.S. parent may be able to deduct the royalty payments from its U.S. profits when calculating its U.S. corporate tax. This strategy can be particularly effective for intellectual property because it is very difficult for the IRS to value such property and hence to challenge the transfer price that members of a multinational group pay for the intra-group transfer or use of their property.

Before the 2017 tax law, multinational corporations could permanently avoid U.S. tax by engaging in these and other profit-shifting schemes because overseas profits generally were not subject to the U.S. corporate tax until (or unless) the corporations "repatriated" them — that is, brought the profits back to the U.S., typically as dividends to the parent company. Corporations often kept those profits overseas, deferring U.S. tax indefinitely. The 2017 tax law made several changes to the tax code's international tax provisions, but corporate profit shifting remains a major problem. As of 2020, three years after the law's enactment, over half of U.S. multinationals' foreign profits were booked in the seven most prominent tax havens, an amount little changed from before the law.[1]

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[1] Wendy Edelberg, Chye-Ching Huang, and Rose Jenkins, "Six Economic Facts on International Corporate Taxation," Hamilton Project, June 2022, https://www.hamiltonproject.org/assets/files/Six_Facts_on_International_Corporate_Taxation_-_Final.pdf. Other recent research on profit-shifting trends finds similar results. For example, a new working paper found that the share of U.S. multinationals' foreign profits booked in tax havens stayed relatively stable before and after the 2017 tax law, at around 50 percent. See Javier Garcia-Bernardo, Petr Jansky, and Gabriel Zucman, "Did the Tax Cuts and Jobs Act Reduce Profit Shifting by US Companies?" May 20, 2022, https://gabriel-zucman.eu/files/GBJZ2022.pdf.

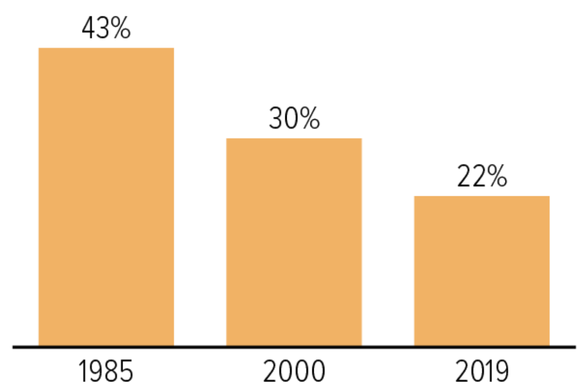
Profit shifting costs significant revenue: prior to the 2017 tax law, U.S. tax revenue losses from profit shifting exceeded $100 billion each year, according to Kimberly Clausing, a UCLA law professor and former Deputy Assistant Secretary for Tax Analysis in the U.S. Treasury Department.[2] That amount has since fallen because the 2017 tax law cut the corporate tax rate from 35 percent to 21 percent, so the U.S. loses less revenue when corporations shift profits, but is still significant. Moreover, this problem is not unique to the United States. Globally, multinational corporations shift to tax havens about 36 cents of every dollar they make in profits, research suggests.[3]

Multinational corporations have also benefited from a broader decline in corporate tax rates. Rates have declined steadily among the Organisation for Economic Co-operation and Development (OECD) countries in recent decades — from an average statutory tax rate of 43 percent in 1985 to just 22 percent in 2019.[4] (See Figure 1.) Countries have lowered their tax rates to attract increasingly mobile business activity (and tax revenue) at the expense of other nations, creating a corporate tax "race to the bottom."[5]

FIGURE 1

Corporate Tax Rates Have Declined in Recent Decades

Average statutory corporate rate among Organisation for Economic Co-operation and Development (OECD) countries



Source: Clausing, "Taxing Multinational Companies in the 21st Century"

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2017 Tax Law Needs Strengthening to Limit Profit Shifting

The centerpiece of the 2017 tax law was a cut in the corporate tax rate from 35 percent to 21 percent and a shift toward a "territorial" tax system, which exempts certain foreign income of U.S. corporations from tax. The law added several provisions, including the GILTI minimum tax, to try to limit the incentive for profit shifting that a territorial tax system exacerbated. These provisions have serious design flaws, however, and leave significant room for tax-motivated profit shifting. Nevertheless, GILTI represents the first such tax that any country has tried to implement, and it — along with the tax code's other international provisions — can be strengthened to deter profit shifting more effectively.

The reconciliation bill passed by the House late last year would make important reforms to the 2017 law's international tax framework, including the GILTI minimum tax and the BEAT, to reduce

[2] Kimberly A. Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act," *National Tax Journal,* Vol. 73, No. 4, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3274827.

[3] Thomas Tørsløv, Ludwig Wier, and Gabriel Zucman, "The Missing Profits of Nations," August 10, 2021, https://gabriel-zucman.eu/files/TWZ2021.pdf.

[4] Kimberly A. Clausing, "Taxing Multinational Companies in the 21st Century," Hamilton Project, January 28, 2020, https://www.hamiltonproject.org/assets/files/Clausing_Book_LO_FINAL.pdf.

[5] See Michael P. Devereux, Ben Lockwood, and Michela Redoano, "Do Countries Compete over Corporate Tax Rates?" *Journal of Public Economics,* Vol. 92, 2008, pp. 1210-35.

the U.S. tax code's favorable treatment of foreign profits and investments. The reforms would raise substantial new revenue — around $250 billion over ten years, according to JCT[6] — that could fund new investments or address long-term fiscal challenges, benefiting U.S. workers, families, and businesses.

Strengthening GILTI Would Capture More Foreign Income

Currently, the GILTI minimum tax is supposed to ensure that U.S. companies pay at least a 10.5 percent tax rate on their foreign profits. The tax applies to a firm's annual foreign income that exceeds 10 percent of its investment in tangible assets (such as factories and equipment) in foreign countries. The goal of setting the applicable minimum tax rate is to reduce the incentive to shift profits by shrinking the gap between the tax rates paid on U.S. income and on foreign income. But this low 10.5 percent rate still leaves significant room for tax-motivated profit shifting since it is only *half* the rate that U.S. corporations face on their domestic profits. In many cases, there is still a large tax advantage for corporations that earn or book their income overseas.

GILTI's other design flaws further increase the tax advantage for foreign income. Crucially, the tax is calculated based on a multinational's *global* income and non-U.S. taxes, instead of its income and taxes for each country separately.[7] This allows multinationals to blend their taxes and income from both high- and low-tax countries (i.e., tax havens) in order to secure as low a global tax rate as possible, and possibly to avoid the U.S. minimum tax altogether. For example, a multinational can use the taxes that it pays on profits from a retail outlet in Mexico (which has a 30 percent corporate tax rate) to shield from the U.S. minimum tax the profits it reports in tax havens like Bermuda (where it faces no corporate tax). Additionally, the exemption of income exceeding 10 percent of the firm's foreign investment in tangible assets may give multinationals an incentive to locate physical investments overseas because the more their foreign tangible property is worth, the lower their GILTI tax will be.

A well-designed minimum tax on foreign profits should ensure that U.S. multinationals' foreign profits are subject to tax at a rate closer to the rate that applies to domestic profits and that more foreign profits are subject to the tax, which would greatly reduce the tax savings from reporting income offshore. The House-passed bill includes several changes to achieve that aim.

In particular, the bill would raise the GILTI tax rate to just over 15 percent, significantly reducing the gap between the GILTI rate and the domestic corporate rate. The bill would also reduce the exemption for income from overseas tangible assets from 10 percent to 5 percent, ensuring that more foreign profits face the tax and lessening the potential incentive for multinationals to locate tangible assets overseas. And it would require multinationals to calculate the minimum tax in each country in which they operate instead of on an aggregate global basis.

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[6] Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions of Title XIII – Committee on Ways and Means, of H.R. 5376, the 'Build Back Better Act,' as Reported by the Committee on the Budget, with Modifications (Rules Committee Print 117-18)," November 4, 2021, https://www.jct.gov/publications/2021/jcx-45-21/.

[7] Similar to previous law, under GILTI companies also receive a credit for the foreign taxes they pay. This credit amounts to 80 percent of their foreign taxes. A firm paying $100 in foreign taxes can thus reduce its U.S. minimum tax by $80.

This country-by-country calculation is particularly important. As NYU law professor David Rosenbloom has said, the current rule allowing multinationals to calculate GILTI on an aggregate global basis:

> … creates a great incentive to send investment outside the United States because averaging always produces an incentive to go outside the United States. If you are low [that is, if your average foreign tax rate is below GILTI's minimum 10.5 percent level], you have an incentive to average up by going outside the United States; if you are high, you have an incentive to go abroad to bring the average down.[8]

That is, under current law, GILTI's global averaging feature makes "the U.S. the *least* desirable place to book income for many multinational companies."[9] Calculating GILTI in each country separately, on the other hand, would remove these incentives by ensuring that every dollar of income reported in a tax haven faces the minimum tax rate. As the Senate moves forward with a reconciliation package, this country-by-country approach to calculating GILTI should be a top priority.

Strengthening Ineffective BEAT Would Reduce Profit Shifting

The 2017 law created another anti-abuse tax, known as the BEAT, to limit a profit-shifting strategy known as "earnings stripping," in which companies move profits from the U.S. to tax havens by making certain types of large, tax-deductible payments, such as interest payments, to a foreign affiliate (that is, a company in a foreign country that has the same corporate owner or owners).

Such profit-shifting payments are particularly harmful when made between companies owned by a foreign-based multinational. That's because the *foreign* income of a foreign-headquartered multinational corporation is not subject to the GILTI minimum tax; only the income it reports within the U.S. is subject to any U.S. corporate tax. So those profit-shifting payments that are "stripped" from the U.S. may never face any tax.

The BEAT is supposed to penalize profit shifting by adding an extra tax when profit-shifting payments are especially large. But in its current form it likely does little to discourage profit shifting. For example, the BEAT only applies if profit-shifting payments exceed a certain threshold, and only if the corporation's tax liability, calculated without allowing deductions for profit-shifting payments and using a tax rate of 10 percent, exceeds the corporation's regular tax liability. This effectively means that for the BEAT to apply, profit-shifting payments must account for more than *half* of a corporation's U.S. profits.[10] Moreover, the BEAT excludes an important type of profit-shifting

[8] Symposium, "The Future of the New International Tax Regime," *Fordham Journal of Corporate and Financial Law*, Vol. 24, No. 2, 2019, https://ir.lawnet.fordham.edu/jcfl/vol24/iss2/1/.

[9] Clausing, "Profit Shifting Before and After the Tax Cuts and Jobs Act."

[10] Bret Wells, "Get With the BEAT," *Tax Notes,* February 19, 2018, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3143891.

payment, the cost of inventory, making it easier for companies to avoid the tax.[11] These flaws allow a large amount of profit shifting to occur without penalty.

The House-passed bill would make the BEAT a more robust deterrent against profit shifting by, for example, ensuring that more types of profit-shifting payments are penalized and raising the applicable penalty tax rate. It would also focus the BEAT where it will have the greatest impact on profit shifting by applying it to payments that are not subject to a minimum level of tax, such as under the GILTI minimum tax.

Implementing International Reforms Would Limit Global Profit Shifting

The House bill's international tax changes are especially important because they would more closely align U.S. laws with the recent multilateral agreement to modernize the international tax system. That agreement is the result of a years-long effort among OECD countries to address the related problems of profit shifting and tax-rate competition, as well as other emerging issues in international taxation.[12]

Under the OECD agreement — which more than 130 countries have signed and the G20 (a group of the 20 countries with the largest economies) has formally endorsed — countries committed to enacting a 15 percent global minimum tax on the profits of large multinational corporations.[13] Under the deal's terms, if a corporation records profits outside of its home country that aren't taxed at a 15 percent effective tax rate — for example, if the company shifts profits to a tax haven — the company's home country will collect additional tax to make sure the income is taxed at a 15 percent rate.

The OECD minimum tax works similarly to the current GILTI minimum tax, with certain features that are stronger than the existing GILTI rules. In particular, the OECD minimum tax sets a higher tax rate (15 percent versus 10.5 percent).[14] Like the House-passed version of GILTI, it also requires that corporations calculate the minimum tax in each country in which they operate instead of on an aggregate global basis. These features will better deter profit shifting by reducing the tax benefits that multinationals get from shifting profits and investments to low-tax countries.

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11 Alexander C. Davis, "The COGS Exception Should BEAT It: A Policy Analysis of the Base Erosion and Anti-Abuse Tax's COGS Exception," *Columbia Journal of Transnational Law,* September 11, 2020, https://www.jtl.columbia.edu/journal-articles/the-cogs-exception-should-beat-it-a-policy-analysis-of-the-base-erosion-and-anti-abuse-taxs-cogs-exception; PwC, "Taxpayers may be able to reduce BEAT liability by increasing cost of goods sold," June 27, 2018, https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-reduce-beat-liability-by-increasing-cost-of-goods-sold.pdf.

12 Another component of the OECD deal, known as "Pillar One," enables countries to tax certain profits of very large, highly profitable multinational corporations with local sales but no local physical presence. Currently, countries tax large multinationals based on the location of their headquarters and operations (e.g., where employees are located). Under the OECD agreement, for multinationals with annual revenues over 20 billion euros and profit margins above 10 percent, a portion of their profits would instead be taxed by countries where they have sales but no physical presence. This means that, under Pillar One, a portion of the profits that would otherwise be taxed by a company's "home" country will instead be taxed by a different country.

13 OECD, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy," October 8, 2021, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm. The minimum tax applies to companies with more than 750 million euros in annual revenue.

14 The GILTI rate is scheduled to increase to 13.125 percent after 2025 under current law.

The OECD rules also contain a backstop to the minimum tax to prevent companies from avoiding the minimum tax by moving their headquarters to a country that hasn't implemented the tax. This provision, known as an under-taxed profits rule (UTPR), allows a country to levy extra taxes on a foreign multinational that operates within its borders if that company is based in a country without an adequate 15 percent minimum tax. The UTPR is designed to encourage those lower-tax countries to enact strong minimum taxes of their own by eliminating the incentive for multinationals to shift profits to them. The U.S.'s BEAT — *with* the House-passed reforms — would function similarly to the UTPR.[15]

When fully implemented, the OECD minimum tax will ensure that multinationals are taxed at a 15 percent rate in each country in which they operate, including their home country and through foreign subsidiaries. This will also help ensure that companies' decisions on where to locate and book profits are based on economic factors, not on differences in countries' corporate tax systems. More broadly, a global corporate minimum tax will help curtail the corporate tax race to the bottom by setting a floor for corporate tax rates.

Policymakers Should Enact Reforms This Year

The OECD deal marks an important step toward international coordination to end profit shifting, but now individual governments, including the U.S., must implement its terms. In the U.S., the revenue-raising reconciliation bill lawmakers are currently considering offers the best opportunity for lawmakers to enact the House-passed reforms to the existing GILTI and BEAT taxes.

Those reforms are important even apart from the OECD deal because they would address major flaws of the 2017 tax law. But the case for action is even stronger in the wake of the OECD agreement. The House measures would more closely align the GILTI and BEAT with the OECD's minimum tax and UTPR. Enacting these reforms now would also push other countries to enact their own minimum taxes; this, in turn, would not only raise substantial global revenue but also benefit U.S.-based multinationals (many of which already pay minimum taxes under GILTI) as well as U.S. companies that do not operate overseas and struggle to compete with corporations that reduce their taxes through profit shifting.

Failure to enact the House bill's international changes, on the other hand, could have serious negative consequences. If the U.S. fails to act and other countries begin implementing the UTPR, U.S.-based multinational companies could face extra taxes by foreign governments if U.S. companies aren't subject to an adequate minimum tax under U.S. tax laws. That is, U.S. companies could end up paying higher taxes to foreign governments — revenues that the U.S. government would have collected if it had imposed a minimum tax. These lost revenues could be used to fund urgent national priorities.

The Senate should act quickly to include these key international tax reforms in its reconciliation bill.

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[15] President Biden's 2023 budget proposed an even more significant change, including replacing the BEAT with a more effective profit-shifting deterrent known as an under-taxed profits rule. The President's proposal would align with the OECD agreement more closely than the BEAT, even with the reforms in the House bill.