

Written Testimony before the U.S. Senate Committee on Finance

May 11, 2023

Daniel Bunn
President & CEO, Tax Foundation

Written Testimony to the United States Senate Committee on Finance, U.S. Congress

Chairman Wyden, Ranking Member Crapo, and distinguished members of the Senate Finance Committee, thank you for the opportunity to provide testimony on the international tax system. I am Daniel Bunn, President & CEO of Tax Foundation.

I am going to cover three topics in my testimony today. First, I'll share my views on the motivations and effects of the reforms introduced by the Tax Cuts and Jobs Act (TCJA). Second, I will discuss how current levels of tax uncertainty undermine the goals of these reforms and how that uncertainty is connected to the global minimum tax. Finally, I will talk about a strategic approach to changing U.S. cross-border tax rules.

International tax rules in the U.S. were overhauled as part of the Tax Cuts and Jobs Act in 2017. The changes shifted how U.S. companies structured their investments abroad and led to some onshoring of intellectual property (IP).

In 2021, more than 130 countries agreed to an outline for international tax reform.¹ That outline described ambitious proposals to change the taxation of large multinational corporations with a shift in their tax base toward market countries alongside a global minimum tax. The two pieces, known as Pillar One (the shift in the tax base) and Pillar Two (the global minimum tax), will impact the way large businesses arrange their tax affairs and the way governments design their tax policies.

This year, more than two dozen countries are expected to put the global minimum tax rules in place, and U.S. tax rules are on a collision course with those global rules.² That is because U.S. tax rules adopted in both the TCJA and the Inflation Reduction Act (IRA) differ significantly from the global minimum tax rules.

Rather than supporting a true safe harbor for U.S. rules, the U.S. Treasury Department has negotiated a deal that exposes the U.S. tax base in serious ways. Congressional action is needed to limit U.S. companies' exposure to multiple layers of taxation and compliance that will hinder their ability to compete on a global scale.

1 OECD/G20 Base Erosion and Profit Shifting Project, "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy," OECD, Jul. 1, 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-july-2021.pdf>.

2 Mindy Herzfeld, "A Pillar 2 Tour Around the World," *Tax Notes Today Federal*, Apr. 17, 2023. <https://www.taxnotes.com/tax-notes-today-federal/transfer-pricing/pillar-2-tour-around-world/2023/04/17/7ggwf>.

Evaluating the TCJA International Rules

The TCJA reforms were not perfect, but they moved the U.S. in the right direction.

It is helpful to consider why a company might want to invest overseas or how it might want to engage foreign customers. A company may be able to expand its U.S. operations and reach foreign consumers either digitally or via the international trading of goods. A company may also determine that the best way to reach foreign customers is by setting up production facilities in locations closer to its customers. Overseas hiring and investment in this case would not be offshoring; it would be necessary to reach foreign consumers. Finally, a company may use a third country as a base for reaching consumers in multiple jurisdictions. This could be due to local natural resources, relevant research facilities and laboratories, or other factors.

Taxes can also play a role in these decisions.

Cross-border tax policy needs to balance at least three objectives. The first should be to support domestic companies in their domestic and overseas expansions as they seek to reach customers, source materials, and expertise from around the world. The second should be to support investment from foreign companies into the domestic market. And the third objective should be to achieve the first two while also protecting the domestic corporate tax base.

The TCJA attempted to accomplish all three.

In terms of the first objective, the TCJA included three major policies to support investment by U.S. companies: reforms to headline tax rates, international rules, and the treatment of capital expenditures.

Prior to the TCJA, the U.S. operated a worldwide tax system with the option to defer taxes on foreign income until the earnings were repatriated, an approach most developed countries had abandoned in favor of a territorial tax system that largely exempts foreign earnings from domestic tax.³ To make matters worse, when U.S. companies brought earnings back, they faced a federal tax rate of 35 percent, which was the highest corporate tax rate in the Organisation for Co-operation and Development (OECD).

The TCJA replaced this with a more competitive 21 percent rate, which, combined with state-level corporate taxes, put the U.S. combined rate at 25.81 percent. In 2022, this was just above the average of 23.57 percent among countries in the OECD and the worldwide average of 23.37 percent.⁴

The corporate tax rate reduction was paired with the introduction of a dividends received deduction, a feature common to territorial tax systems.⁵ The dividends received deductions means that foreign earnings could be brought back to U.S. shareholders without an additional layer of U.S. tax—the old repatriation tax was eliminated.

3 Tax Foundation, "What Is Worldwide Tax System?," accessed May 2, 2023, <https://taxfoundation.org/tax-basics/worldwide-taxation/>.

4 Cristina Enache, "Corporate Tax Rates Around the World," Tax Foundation, Dec. 13, 2022, <https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/>.

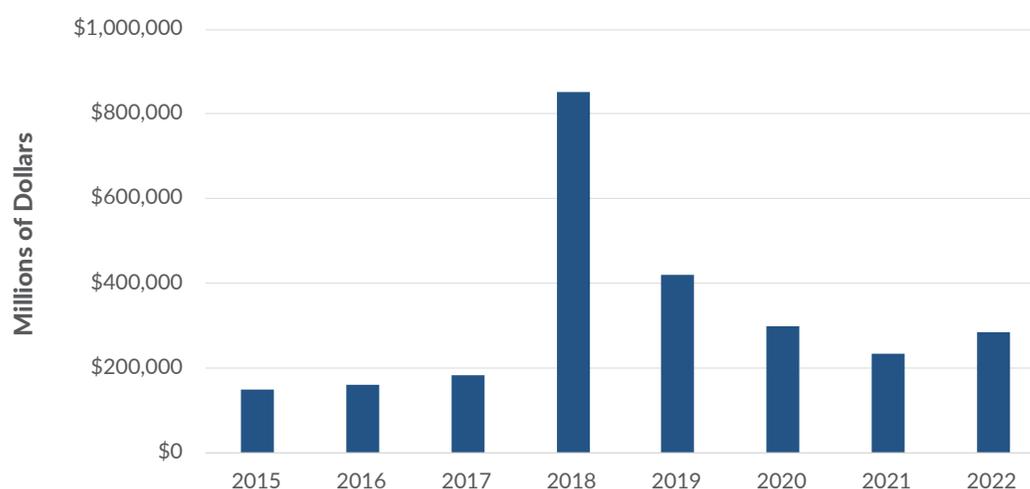
5 Tax Foundation, "What Is Territorial Tax System?," accessed May 2, 2023, <https://taxfoundation.org/tax-basics/territorial-taxation/>.

In the five years immediately following the passage of the TCJA (2018-2022), companies repatriated \$2.1 trillion in foreign earnings. That is a dramatic increase relative to the five years leading up to tax reform (2013-2017), when companies repatriated just \$797 billion.⁶

FIGURE 1.

Repatriation Rose Significantly Following Tax Cuts and Jobs Act

Receipts of Cross-Border Dividends and Withdrawals



Source: U.S. Bureau of Economic Analysis, "Table 4.2 U.S. International Transactions in Primary Income on Direct Investment."

Looking at just 2021 and 2022 versus 2016 and 2017, repatriations are averaging 0.04 percentage points higher as a share of gross domestic product. That is nearly \$43 billion in additional repatriated earnings each year available to U.S. companies that are looking to invest in production and their workforce or return cash to shareholders.

A working paper from academic accountant Brooke Beyer and his coauthors on the usage of repatriated dollars has found that U.S. multinationals with low domestic liquidity and high domestic investment opportunities responded to the TCJA changes with more domestic capital expenditures.⁷ In this way, opportunities for getting goods and services to consumers have been combined with a lower U.S. tax burden to support investment in the U.S.

In addition to the corporate rate reduction and the dividends received deduction, the TCJA introduced the policy of immediate expensing for a large portion of capital investments (equipment and other short-lived assets) which is now expiring.⁸ The changes to the corporate tax rate and the adoption of immediate expensing had the effect of lowering the marginal tax rate on domestic investment, improving incentives for business investment.⁹

⁶ Bureau of Economic Analysis, "Table 4.2. U.S. International Transactions in Primary Income on Direct Investment, Receipts, Dividends and Withdrawals," Mar. 23, 2022.

⁷ Brooke Beyer et al., "Early Evidence on the Use of Foreign Cash Following the Tax Cuts and Jobs Act of 2017," *Social Science Research Network*, Apr. 2, 2021, <https://doi.org/10.2139/ssrn.3818149>.

⁸ Garrett Watson et al., "Canceling the Scheduled Business Tax Increases in Tax Cuts and Jobs Act," Tax Foundation, Nov. 1, 2022, <https://taxfoundation.org/tax-cuts-jobs-act-business-tax-increases/>.

⁹ John McClelland and Jeffrey Werling, "How the 2017 Tax Act Affects CBO's Projections," Congressional Budget Office, Apr. 20, 2018, <https://www.cbo.gov/publication/53787>; Huaqun Li and Kyle Pomerleau, "The Distributional Impact of the Tax Cuts and Jobs Act over the Next Decade," Tax Foundation, Jun. 28, 2018, <https://taxfoundation.org/the-distributional-impact-of-the-tax-cuts-and-jobs-act-over-the-next-decade/>.

These policies were also useful in terms of the second objective, becoming an attractive investment destination for foreign companies.

A working paper by economist Thornton Matheson and her coauthors finds inbound foreign direct investment financed out of retained earnings increased following the adoption of the TCJA.¹⁰

Looking at the third objective for cross-border tax rules brings one to the alphabet soup of the TCJA. In trying to achieve the goals of foreign success of domestic companies and domestic success of both foreign and domestic companies while protecting the U.S. tax base, the TCJA brought in two minimum taxes and one reduced tax rate.

The first global minimum tax was adopted by the U.S. as part of the TCJA. The policy, the tax on Global Intangible Low-Taxed Income (GILTI), was paired with an incentive for holding IP within the U.S. (the Foreign-Derived Intangible Income [FDII]), and a disincentive for cross-border cost shifting (the Base Erosion and Anti-Abuse Tax [BEAT]).¹¹

These reforms broadened the U.S. tax base in several ways.

GILTI expanded the scope of U.S. companies' foreign profits that face additional tax by the U.S. on an annual basis. Prior to the TCJA, companies could defer U.S. tax liability on their foreign earnings until the earnings were repatriated. Following the TCJA, foreign profits above a 10 percent return on assets face at least a 10.5 percent minimum tax rate from GILTI, and foreign earnings can be repatriated without an additional toll tax.¹²

In many cases, the tax rate companies face under GILTI is 13.125 percent or higher. The higher rate is because foreign tax credits are limited to 80 percent of their value and some domestic expenses are allocated to foreign earnings. The combined tax (foreign taxes plus U.S. taxes) on the U.S. share of foreign profits, recently estimated by Tax Foundation economist Cody Kallen, was 19.3 percent under current law for 2022.¹³ Under current law in 2031, the combined tax on foreign profits of U.S. companies would rise to 20.7 percent. This is primarily because the tax rate on GILTI is scheduled to rise after 2025.

By design, GILTI has changed the incentives for investing in foreign low-tax jurisdictions because the floor for foreign tax rates is no longer zero.

A working paper by economist Matthias Dunker and his coauthors examines how GILTI impacted incentives for companies to acquire businesses in foreign low-tax jurisdictions. Compared to companies not impacted by GILTI, they find that GILTI-affected firms have been less likely to merge with or acquire foreign companies in low-tax locations. Their research also shows that acquisition

10 Thornton Matheson et al., "The Impact of the Tax Cuts and Jobs Act on Foreign Investment in the United States." IMF Working Papers 22/79, May 2022, <https://www.imf.org/en/Publications/WP/Issues/2022/05/06/The-Impact-of-the-Tax-Cuts-and-Jobs-Act-on-Foreign-Investment-in-the-United-States-517616>.

11 For more information on the mechanics of these policies, see Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act," Tax Foundation, May 2018, <https://files.taxfoundation.org/20180502205047/Tax-Foundation-FF586.pdf>.

12 Tax Foundation, "Global Intangible Low Tax Income (GILTI)," accessed May 2, 2023. <https://taxfoundation.org/tax-basics/global-intangible-low-tax-income-gilti/>.

13 Cody Kallen, "How Heavily Taxed Are U.S. Multinationals?," Tax Foundation, Sep. 29, 2021, <https://www.taxfoundation.org/us-multinational-corporations-tax/>.

targets for U.S. companies impacted by GILTI tend to be less profitable.¹⁴ Similarly, research by academic accountants Harald Amberger and Leslie A. Robinson suggests the TCJA reforms reduced the amount of tax-motivated cross-border acquisitions by U.S. firms.¹⁵

Companies facing additional tax through GILTI could make foreign investments to minimize their GILTI exposure due to the exclusion of a 10 percent return on qualified business asset investment (QBAI).¹⁶ Previously mentioned research from academic accountant Brooke Beyer and coauthors suggests that GILTI led to an increase in foreign capital expenditures.¹⁷

The next way TCJA broadened the tax base was via FDII, which was designed to provide a lower tax rate of 13.125 percent on profits from exports related to IP held within the U.S. The goal of the lower tax rate was to incentivize businesses to keep their software, patents, or copyrights in the U.S. rather than offshoring them to a foreign low-tax jurisdiction. In some cases, businesses have returned IP assets to the U.S. in recent years.

When IP assets are held offshore, the U.S. tax base only benefits to the extent that GILTI or other rules addressing tax avoidance apply. When IP assets are in the U.S., the IRS has the primary right to tax related earnings.

Research focused on company financial statements has identified U.S. companies that specifically benefited from FDII because they restructured their IP holdings.¹⁸ Additionally, recent research by economist Javier Garcia-Bernardo and his coauthors shows the driving force behind a reduction in the share of profits that U.S. companies book abroad was repatriations of IP.¹⁹

One interesting indicator of this is exports of IP services to foreign jurisdictions, particularly to Ireland. For tax reasons, many U.S. companies have deployed investments in Ireland as part of their corporate structures and investment strategies in recent decades. Prior to 2020, they also regularly used entities in the Netherlands and zero-tax jurisdictions to minimize the amount of taxes paid on profits from IP.²⁰

However, since 2020—the year many Irish structures became unavailable to companies such strategies have no longer been viable.²¹ Consequently, many U.S. companies brought IP back to the U.S. to serve Irish (and other) markets with IP held in the U.S. Since the start of 2020, U.S. exports of IP services to Ireland have skyrocketed.

14 Mathias Dunker, Michael Overesch, and Max Pflitsch, "The Effects of the U.S. Tax Reform on Investments in Low-Tax Jurisdictions – Evidence from Cross-Border M&As," Social Science Research Network, Sep. 28, 2021, <https://doi.org/10.2139/ssrn.3932459>.

15 Harald Amberger and Leslie A. Robinson, "The Initial Effect of U.S. Tax Reform on Foreign Acquisitions," Social Science Research Network, Feb. 6, 2023, <https://doi.org/10.2139/ssrn.3612783>.

16 "What Is the Qualified Business Asset Investment (QBAI) Exemption?," Tax Foundation, accessed May 2, 2023, <https://taxfoundation.org/tax-basics/qualified-business-asset-investment-qbai-exemption/>.

17 Beyer et al., "Early Evidence on the Use of Foreign Cash Following the Tax Cuts and Jobs Act of 2017."

18 Martin A. Sullivan, "Latest SEC Filings Show FDII Benefits Continue to Climb," *Tax Notes Today International*, Apr. 10, 2023, <https://www.taxnotes.com/tax-notes-today-international/corporate-taxation/latest-sec-filings-show-fdii-benefits-continue-climb/2023/04/10/7g9qj>.

19 Javier Garcia-Bernardo, Petr Janský, and Gabriel Zucman, "Did the Tax Cuts and Jobs Act Reduce Profit Shifting by US Multinational Companies?," National Bureau of Economic Research, May 2022, <https://www.nber.org/papers/w30086>.

20 Daniel Bunn, "New Research Shows Major Changes for U.S. Companies Earning Profits from Ireland," Tax Foundation, Jun. 16, 2021, <https://taxfoundation.org/us-companies-earning-profits-ireland/>.

21 Ibid.

From the start of 2020 to the end of 2022, Irish entities had imported €243.8 billion (\$267.9 billion) in IP services from the U.S.—more than triple the IP services imports in the previous decade.

Much of the IP that has been shifted back to the U.S. has come from offshore financial centers such as Bermuda and the Cayman Islands.²²

FIGURE 2. Irish Imports of U.S. IP Services Rose Dramatically Starting in 2020

Irish Imports of IP Services from the U.S. (Royalties)



Source: Eurostat, "Balance of payments by country – quarterly data (BPM6); Services: Charges for the use of intellectual property n.i.e."

The next expansion of the U.S. tax base is the BEAT. Like the tax on GILTI, the BEAT is a minimum tax. It is meant to address tax-planning schemes where large multinationals make cross-border payments within their businesses to limit their exposure to U.S. taxes. Since outbound payments are often deductible in the U.S., and the "income" to a foreign subsidiary may be taxed more lightly, such payments have been known to "strip" otherwise taxable income out of the U.S. into low-tax jurisdictions. The BEAT rate is 10 percent and applies to companies with more than \$500 million in total revenues and total cross-border payments that exceed 3 percent (2 percent for some financial companies) of deductions.²³

GILTI, FDII, and BEAT are imperfect. The burden of GILTI and its interaction with foreign tax credit rules means it operates more like a surtax than a minimum tax. The BEAT is an inelegant approach to addressing tax avoidance via cross-border shifting. Like any alternative tax measure, it can erode tax incentives. FDII also was not perfect, but its imperfections are more about the policy narrative adopted by the current administration rather than problems with the policy itself. Specifically, the

22 Seamus Coffey, "The changing nature of outbound royalties from Ireland and their impact on the taxation of the profits of US multinationals – May 2021," Ireland Department of Finance, Jun. 14, 2021, <https://www.gov.ie/en/publication/fbe28-the-changing-nature-of-outbound-royalties-from-ireland-and-their-impact-on-the-taxation-of-the-profits-of-us-multinationals-may-2021/>.

23 The BEAT rate is scheduled to rise to 12.5 percent beginning in 2026. The \$500 million in revenues is measured as a three-year moving average. The BEAT rate of 10 percent applies to a U.S. company's taxable income plus the value of base erosion payments minus liability for normal corporate tax. For an example of a BEAT calculation, see Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act."

Biden administration has proposed to eliminate FDII and replace it with unspecified research and development (R&D) incentives.²⁴

With domestic investment, inbound investment, and shifts in IP holdings connected to the TCJA changes, it is clear that these changes were in the right direction, even with their imperfections.

Research focused on the change in business tax burdens after tax reform has found that domestic income received a significantly larger tax cut than foreign income. The finding is not surprising since the corporate tax rate was reduced so significantly, and the tax cut received by multinational companies was driven by the change in their domestic tax liability. The tax burden on foreign earnings did not change significantly. Even after accounting for the switch to the new cross-border rules, the foreign activities of U.S. multinationals face similar levels of tax compared to the previous system.²⁵

One final point of evidence is how the TCJA changed the competitiveness of U.S. multinationals. Leading up to the passage of the TCJA, Bloomberg documented dozens of U.S. companies that moved their headquarters outside the U.S. between 1982 and 2017.²⁶ Since tax reform, this has essentially stopped.²⁷ It is safe to say that relative to U.S. tax rules in place before the 2017 reform, U.S.-headquartered companies are much more competitive with their global peers.

Moving into the Fog

The goals of the Tax Cuts and Jobs Act are now being undermined by a climate of uncertainty surrounding U.S. tax rules. The adoption of global minimum tax rules around the world, the administration's proposal to repeal FDII, and upcoming rate changes to GILTI and BEAT after 2025 in the context of potentially unstable political coalitions all spell a recipe for uncertainty.²⁸

Certainty and stability are hard to measure, but they are strong contributors to a competitive policy environment.

Uncertainty stems first from the global minimum tax rules. These rules do not match up with U.S. tax rules or concepts, and many U.S. companies are currently preparing to comply with yet another layer of minimum taxes even though Congress has not acted.

There is also uncertainty about the legality and enforceability of the global minimum tax rules. Any policy harmonization project involving dozens of jurisdictions and their own national legal frameworks will run into challenges, and the global minimum tax is no different.

Uncertainty also exists for congressional lawmakers trying to chart the correct policy course.

24 "General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals" Department of the Treasury, Mar. 9, 2023, <https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf>.

25 Scott Dyreng et al., "The Effect of U.S. Tax Reform on the Tax Burdens of U.S. Domestic and Multinational Corporations," Social Science Research Network, Jun. 5, 2020, <https://doi.org/10.2139/ssrn.3620102>.

26 "Tracking Tax Runaways," Bloomberg.Com, Apr. 13, 2023, <https://www.bloomberg.com/graphics/tax-inversion-tracker/>.

27 Mindy Herzfeld, "Designing International Tax Reform: Lessons from TCJA," *International Tax and Public Finance* 28: 5 (2021): 1163–87, <https://doi.org/10.1007/s10797-021-09675-0>.

28 The Biden administration has proposed to repeal FDII and replace it with unspecified research and development incentives, see "General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals" Department of the Treasury, Mar. 9, 2023, <https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf>.

In the fall of 2021, the Build Back Better Act (BBBA) passed through the House of Representatives. The package included changes to GILTI, FDII, and BEAT. Some of the proposals would have improved the way the policies work relative to current law, primarily the GILTI provisions that would limit the amount of domestic expenses allocated to foreign profits.

A major challenge for legislators at the time was that the model rules for the global minimum tax had not yet been released. If U.S. legislators had the model rules in hand when designing the provisions of the BBBA, it is likely they would have made different choices.

The model rules for the global minimum tax were released in December 2021.²⁹ Further commentary and examples of how the rules might apply were released in March 2022, and administrative guidance was released in February 2023.³⁰

Key differences between the model rules and the administrative guidance have increased the need for Congress to act to avoid a chaotic outcome for U.S. companies in the coming years.

But without coordination between Congress and the U.S. Treasury Department, lawmakers may continue to be uncertain about appropriate changes that can protect the U.S. tax base and maintain U.S. competitiveness.

The global minimum tax establishes a 15 percent effective tax rate based on the adjusted financial statement income of large corporate entities on a jurisdiction-by-jurisdiction basis. Under the minimum tax, a company would need to calculate the effective tax rate its operations face in each jurisdiction where it has sufficient profits. After accounting for normal corporate income taxes, a top-up may be assessed to ensure the effective tax rate in a jurisdiction is 15 percent. A substance-based income exclusion is provided both for a share of tangible assets and payroll.

The rules also use a global revenue threshold of €750 million (\$790 million) in at least two of the previous four fiscal years with an optional exclusion for entities in a jurisdiction with average revenues below €10 million (\$10.55 million) or income less than €1 million (\$1.05 million) (the average is calculated using the current year and two previous years). The thresholds determine whether a company needs to comply with the rules in general or in a specific jurisdiction.³¹

The rules lay out four tools for implementing top-up taxes on low-taxed income. Generally, the first three rules apply to the same definition of taxable income, but they differ in which jurisdiction might apply the rule and where a multinational might send its tax payment for the top-up.

29 OECD, "Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two)," Dec. 20, 2021, <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>.

30 See "OECD Releases Detailed Technical Guidance on the Pillar Two Model Rules for 15% Global Minimum Tax - OECD," accessed May 2, 2023, <https://www.oecd.org/tax/beps/oecd-releases-detailed-technical-guidance-on-the-pillar-two-model-rules-for-15-percent-global-minimum-tax.htm>; "International Tax Reform: OECD Releases Technical Guidance for Implementation of the Global Minimum Tax - OECD," accessed May 2, 2023, <https://www.oecd.org/tax/international-tax-reform-oecd-releases-technical-guidance-for-implementation-of-the-global-minimum-tax.htm>.

31 No such exclusion thresholds are available for U.S. companies under GILTI (current law or in the BBBA).

The three main rules of the global minimum tax are as follows:

1. Qualified Domestic Minimum Top-Up Tax (QDMTT): Applies to low-tax profits within a jurisdiction's own borders
2. Income Inclusion Rule (IIR): Applies to low-tax profits of foreign subsidiaries of a jurisdiction's own companies
3. Under-Taxed Profits Rule (UTPR): Applies to a local subsidiary of a foreign company that has low-tax profits elsewhere in the world that are not taxed under the other top-up rules; a parent company's low-tax profit could be allocated by formula to a foreign jurisdiction for the purpose of a top-up tax on a local subsidiary

A fourth rule based on tax treaties is the Subject to Tax Rule (STTR), which a country could use to apply a 9 percent tax on payments to related parties taxed below that rate.

Also, the three main rules of the global minimum tax only roughly correspond to proposals in the BBBA passed by the House of Representatives in 2021. For example, the proposed changes to GILTI would not match the tax base of the minimum tax rules as they do not use financial accounting. The substance-based income exclusion would only apply to tangible assets rather than payroll. Additionally, the effective tax rate calculation for GILTI includes a limit on foreign taxes paid (95 percent in the BBBA; current law only provides an 80 percent credit). The per-country effective rate could be 15.8 percent or higher under the BBBA version of GILTI.

The differences, alongside the complexities of U.S. foreign tax credit rules, create significant gaps between the BBBA and the global minimum tax model rules.

Additionally, the book minimum tax adopted in the Inflation Reduction Act in 2022 introduces another definition of adjusted financial statement income that differs from the global minimum tax rules.

Table 1 on the following page provides a comparison of the different rules and how they are distinct from one another.

TABLE 1.

U.S. Takes a Different Approach than the Global Minimum Tax Model Rules

	Current Law Through 12/31/2025	Current Law After 12/31/2025	Inflation Reduction Act Book Minimum Tax	Build Back Better Act (Not Adopted)	Global Minimum Tax Model Rules
Effective Date	1/1/2018	1/1/2026	1/1/2023	Not adopted	Generally 1/1/2024 and later but it depends on the jurisdiction.
Rate	10.5% (could be 13.125% or higher depending on exposure to foreign taxes)	13.125% (could be 16.4% or higher depending on exposure to foreign taxes)	15%	15% (could be 15.8% or higher depending on exposure to foreign taxes)	15%
Exclusion for a Normal Return on Tangible Assets	10% deduction for foreign tangible assets	10% deduction for foreign tangible assets	Tax accounting is used for depreciation deductions	5% deduction for foreign tangible assets	8% incrementally reduced to 5% over the first five years
Exclusion for a Normal Return on Payroll Costs	No	No	No	No	10% incrementally reduced to 5% over the first five years
Loss Carryovers	No	No	Capped at 80% of adjusted financial statement income and limited to losses accrued after 2019	No	Included in Deferred Tax Asset recast at 15% rate
Foreign Tax Treatment	Credit for 80% of foreign taxes paid, no carryover for excess credits	Credit for 80% of foreign taxes paid, no carryover for excess credits	Provides a credit for foreign taxes	Credit for 95% of foreign taxes paid, five-year carryforward of excess foreign tax credits	Deferred Tax Asset recast at 15% rate
Jurisdictional Calculation	Foreign income is blended together	Foreign income is blended together	Applies to the worldwide income of U.S. companies and the U.S. income of foreign companies	Country-by-country	Country-by-country
Threshold for Application	None, 10 percent ownership threshold	None, 10 percent ownership threshold	\$1 billion in financial profits	None, 10 percent ownership threshold	€750 million (\$790 million) in global revenues
Income Definition	Foreign taxable income as defined in the Internal Revenue Code, no use of financial accounting methods	Foreign taxable income as defined in the Internal Revenue Code, no use of financial accounting methods	Financial profits as defined by accounting standards and adjusted to align closer to taxable profits	Foreign taxable income as defined in the Internal Revenue Code, no use of financial accounting methods	Financial profits as defined by accounting standards and adjusted to align closer to taxable profits
Under-Taxed Profits Rule (UTPR)	Base Erosion and Anti-Abuse Tax (not comparable to the OECD model rules)	Base Erosion and Anti-Abuse Tax (not comparable to the OECD model rules)	Base Erosion and Anti-Abuse Tax (not comparable to the OECD model rules)	Base Erosion and Anti-Abuse Tax (not comparable to the OECD model rules)	Yes
Qualified Domestic Minimum Top-Up Tax	None	None	Applies to domestic income, but it is fundamentally different from a QDMTT	15% alternative minimum tax on worldwide financial profits (not comparable to the OECD model rules)	Yes

Source: Author's analysis of the international rules in the Tax Cuts and Jobs Act, the Inflation Reduction Act, and the global minimum tax model rules.

The Pillar Two Rules and the U.S. Tax Base

Under the model rules for the global minimum tax, the taxable income of a large multinational will be taxed through five layers of rules with each consecutive layer depending on how much tax is collected under the previous one:

1. Normal corporate income taxes in the jurisdiction in which income is earned
2. Qualified Domestic Minimum Top-Up Tax (QDMTT) applied by the jurisdiction in which low-tax earnings arise
3. Controlled Foreign Corporation (CFC) rules applied by the jurisdiction of a company's headquarters or owners
4. Income Inclusion Rule (IIR) applied by the jurisdiction of a company's ultimate parent entity on low-tax foreign earnings in each foreign jurisdiction in which the company has low-tax earnings
5. Under-Taxed Profits Rule (UTPR) applied to entities within a jurisdiction on a country's share of low-tax profits of the corporate group that have not already been taxed by one of the previous four rules

The U.S. currently has rules in place for numbers one and three. The U.S. corporate income tax applies at the federal level with a 21 percent rate, though various deductions and credits can result in effective tax rates below 21 percent. The U.S. also has CFC rules that apply to the foreign income of U.S. multinationals in certain circumstances (Subpart F). GILTI also roughly fits into the CFC rules category. Credits for foreign taxes paid can be applied to reduce additional U.S. tax liability, although they are limited to 80 percent of their value for GILTI, and recent regulatory changes have narrowed the scope of creditable foreign taxes.

The order of the minimum tax rules means that both the U.S. tax base through Subpart F and through GILTI will be eroded when other countries adopt a QDMTT. This is because foreign tax credits for QDMTTs would offset the taxes that would otherwise be owed through Subpart F and GILTI. The 80 percent foreign tax credit limit in GILTI means that after a QDMTT applies, any revenue raised through GILTI is double taxation of foreign profits.

The U.S. would be giving up the tax base it currently taxes using GILTI. In fact, the global minimum tax rules incentivize countries to adopt QDMTTs that would apply ahead of IIRs and CFC rules. Research by economists Michael Devereux, John Vella, and Heydon Wardell-Burrus suggests some jurisdictions may prefer to collect corporate taxes through the QDMTT than even the traditional corporate tax.³²

³² Michael P. Devereux, John Vella, and Heydon Wardell-Burrus, "Pillar 2: Rule Order, Incentives, and Tax Competition," Oxford University Centre for Business Taxation Policy Brief, Jan. 14, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009002.

Tax Foundation modeling from 2021 suggests that if enough foreign jurisdictions adjust their corporate income taxes to collect low-tax earnings within their jurisdictions, then aligning GILTI with the global minimum tax would result in a net loss of U.S. federal tax revenue.³³

Unless U.S. cross-border rules change, companies will face GILTI, BEAT, and the new book minimum tax from the Inflation Reduction Act in addition to compliance costs associated with the global minimum tax. This is a higher level of policy complexity and compliance than the foreign competition U.S. companies will face, and Congress should aim to avoid a chaotic enforcement and compliance scenario in the coming years.

The uncertainty in the current environment is driven by the minimum tax rules and their interaction with U.S. rules. In addition to interactions with GILTI and Subpart F, U.S. tax incentives have critical interactions with the global minimum tax rules as well.

U.S. tax credits provided to companies for clean energy initiatives, research and development, or deductions connected to FDII can result in low effective tax rates, exposing the income of a foreign company operating in the U.S. to an IIR. The same can be true for U.S. companies that might be exposed to a UTPR on their low-tax income within the U.S.³⁴

Tax Incentives and the Global Minimum Tax

Many jurisdictions around the world offer tax preferences or structure their tax rules in such a way that allows companies to be taxed at rates below the 15 percent rate envisioned by the minimum tax.

The global minimum tax can create problems for such policies, however. For example, let's say a large multinational company headquartered in Country A makes an investment in Country B that is eligible for a 10-year corporate tax holiday. Even though the profits from the investment will not be taxed by Country B, the global minimum tax would allow Country A to apply the minimum rate of 15 percent to those profits.

Country B may choose to change its tax holiday policy to tax those profits locally rather than allowing the tax revenue to go to Country A. If Country B applies a high corporate tax rate to companies that are not eligible for a tax holiday, the additional revenue from shutting down the preferential policy could support a more general tax reform (broadening the base and lowering the rates, as the mantra goes).

Not all tax policies will follow such a straightforward analysis, however, and the model rules are only helpful in assessing policies to the extent that they result in effective tax rates below 15 percent for large multinational companies.

33 See the second table in Daniel Bunn, "Adoption of Global Minimum Tax Could Raise U.S. Revenue...or Not," Tax Foundation, Aug. 19, 2021, <https://www.taxfoundation.org/us-global-minimum-tax-revenue/>.

34 Daniel Bunn, "U.S. Tax Incentives Could be Caught in the Global Minimum Tax Crossfire," Tax Foundation, Jan. 28, 2022, <https://www.taxfoundation.org/us-global-minimum-tax-build-back-better/>.

At the risk of oversimplifying, I have developed a rough categorization of the policies that countries will most likely need to review in the context of the minimum tax rules. This is shown in Figure 3. Policies facing a Red Light are primarily those that provide a zero effective tax rate. Yellow Light policies provide reduced effective tax rates below 15 percent but not zero. Green Light policies are those that reduce the cost of investment without triggering the minimum tax, unless the general corporate tax rate is very low.

The key items for U.S. lawmakers are in the Yellow Light category. The FDII deduction and non-refundable credits both create a risk of a top-up tax through the global minimum tax rules.

FDII is potentially vulnerable to top-up tax due to its 13.125 percent rate. Lower rates for intangible income are relatively common worldwide; an OECD survey of 49 countries finds 27 have an income-based R&D incentive similar to FDII. The FDII regime is among the larger income-based incentives as a share of its country's economy, though far short of the greatest outliers. In absolute terms, it is the largest in the world.³⁵ The administration's efforts to repeal FDII led the OECD to categorize it as "in the process of being eliminated."³⁶ However, Congress has not yet agreed on legislation to eliminate FDII, and its status both domestically and with the OECD remains in doubt.

Due to the reliance on accounting standards for the global minimum tax rules, non-refundable tax credits are treated worse than refundable credits. However, it is not a simple matter to change non-refundable credits into refundable credits. Recent analysis by PwC suggests that transforming both FDII and general business credits into refundable programs could decrease U.S. tax revenue by up to nearly \$200 billion over the 2023-2032 budget window.³⁷ This is before accounting for behavioral changes in response to the provision of refundability.

Uncertainty surrounding the future compatibility of U.S. cross-border tax rules and tax incentives with the global minimum tax directly undermines the TCJA policies meant to support the success of multinationals connected to the U.S. market.

35 Silvia Appelt et al., "Cost and uptake of income-based tax incentives for R&D and innovation," OECD Science, Technology and Industry Working Papers, <https://www.oecd-ilibrary.org/docserver/4f531faf-en.pdf>.

36 OECD, "Harmful Tax Practices – Peer Review Results," Inclusive Framework on BEPS: Action 5, January 2023, <https://www.oecd.org/tax/beeps/harmful-tax-practices-consolidated-peer-review-results-on-preferential-regimes.pdf>.

37 Peter R. Merrill et al., "Where Credit Is Due: Treatment of Tax Credits Under Pillar 2," accessed May 2, 2023, <https://www.taxnotes.com/special-reports/credits/where-credit-due-treatment-tax-credits-under-pillar-2/2023/03/17/7g743#sec-4-1-1>. If only applied to companies with gross revenues \geq €750 million, the cost could be substantially lower.

FIGURE 3.
**Certain Tax Policies Will Require Review
 in the Context of a Global Minimum Tax**

RED LIGHT
<ul style="list-style-type: none"> Tax holidays Zero-tax free trade zones Zero-rate corporate tax systems
YELLOW LIGHT
<ul style="list-style-type: none"> Reduced-rate incentives (e.g., patent boxes or FDII) Business tax credits (particularly non-refundable credits) Direct funding programs Corporate tax rates below 15 percent
GREEN LIGHT
<ul style="list-style-type: none"> Accelerated depreciation (full expensing) Last-In-First-Out (LIFO) inventory treatment Unlimited loss carryforwards Refundable tax credits

Note: The context for review will differ by country. Red Light policies are those most likely to require re-assessment and reform. Yellow Light policies need close study with a goal of simplifying tax incentives in the context of reform. Green Light policies should not need review in light of the minimum tax rules.

Source: Author.

Designing a Strategic Approach for U.S. Reforms

Even though Treasury has not sufficiently coordinated its international negotiations with Congress, it will be Congress' responsibility to minimize the disruption caused by the implementation of the global minimum tax.

Three goals should guide lawmakers:

1. Simplify the taxation of U.S. multinationals
2. Promote investment and innovation in the U.S. in ways that protect the U.S. tax base from foreign top-up taxes
3. Aim for revenue neutral reforms

First, when it comes to simplicity, the foreign tax credit is an important place to start. The foreign tax credit connections between GILTI in current law and the global minimum tax contribute significantly to additional complexity for U.S. multinationals. And recently, the U.S. Treasury has promulgated regulations that have added even more uncertainty around the foreign tax credit.³⁸

38 Daniel Bunn, "A regulatory tax hike on US multinationals," MNE Tax, Feb. 28, 2022, <https://mnetax.com/a-regulatory-tax-hike-on-us-multinationals-46865>.

The current U.S. system is a hybrid system with elements that only focus on activities directly connected to the U.S. and elements that look at a company's global footprint. Other countries that have had territorial systems for many years are now venturing out on this hybrid approach with the global minimum tax. The multinationals that face the minimum tax rules will essentially be operating under a set of rules that apply to their worldwide income.

The tensions between territorial and worldwide rules will create complexity and enforcement challenges for years to come.

Returning to a set of worldwide rules for U.S. companies could be seen as a simplification relative to the complexities of administering a hybrid system and enforcing the global minimum tax rules.

Replacing our current rules with a worldwide tax system with full creditability for foreign taxes could prove simpler for compliance than a reform that tries to align GILTI, BEAT, and the book minimum tax to the global minimum tax rules. This could be done alongside permanent, growth-oriented reforms like returning to expensing for R&D and capital investments.

In 2020, I recommended that a global minimum tax should be designed with full expensing for capital expenditures.³⁹ The minimum tax rules generally do not stand in the way of this policy, so a worldwide tax base that includes full expensing alongside a competitive rate could be a worthwhile effort.

If policymakers choose not to go down the path of worldwide taxation and instead retain a hybrid territorial system, it will be critical to adopt rules that are at the very least compatible with the global minimum tax rules. Having companies calculate taxable income under potentially four different minimum tax regimes would be counterproductive.

Secondly, Congress should promote investment and innovation in the U.S. in ways that protect the U.S. tax base from foreign top-up taxes. To avoid U.S. companies losing tax benefits to foreign UTPRs or foreign companies operating in the U.S. to IIRs, Congress should review existing tax incentives and prioritize them for reform or elimination. Additional revenues from eliminated tax incentives could be used to extend investment-friendly policies that are more compatible with the global minimum tax, such as full expensing for capital investment.⁴⁰

The U.S. should also maintain a relatively low corporate tax rate consistent with the international agreement.

Finally, policy reforms should aim for revenue neutrality. In the area of cross-border taxation, the structure and complexity of the rules matter greatly. But once the structure is set, policymakers should avoid creating unnecessary tax increases for businesses. The TCJA had to trade off revenue reductions in some areas with base broadening, and the same will likely be necessary in the next round of changes to cross-border tax rules.

39 Daniel Bunn, "Designing a Global Minimum Tax with Full Expensing," Tax Foundation, Sep. 23, 2020, <https://taxfoundation.org/designing-a-global-minimum-tax-with-full-expensing/>.

40 For more analysis of the connection between the global minimum tax and tax incentives, see Table III.2 in UNCTAD, "World Investment Report 2022," June 2022, https://unctad.org/system/files/official-document/wir2022_en.pdf.

The choice for Congress is not a simple one between adopting the global minimum tax rules or adopting the reforms to GILTI envisioned in the BBBA. Overall, taking a different approach would provide Congress a chance to simplify cross-border tax rules in a way that supports investment within the U.S. without giving up significant control of the U.S. tax base to foreign jurisdictions.

Conclusion

A lot has changed in international tax rules over the last decade. Congress should explore how new rules have impacted the U.S. tax base and the investment behavior of U.S. companies.

The current level of uncertainty undermines the objectives of the 2017 reforms. Policy changes that move the U.S. rules out of the fog and into longer-term stability would be welcome.

The U.S. international tax system can and should be simplified. Such an achievement would require legislators to focus their efforts on designing rules that fit within the new framework and do not unnecessarily give up control of the U.S. tax base.

Even in the face of a global minimum tax, Congress still has a chance to develop a strategic approach in support of U.S. investment and innovation. It should take that chance.