Tax Foundation University 2024

Course 1: March 1, 2024

Goals of this Session

- **Apportionment:** how do countries divvy up income?
- **Profit shifting:** how do firms try to minimize taxes?
- **Goals of multinational systems:** what are we optimizing?
- **TCJA (2017):** What did our last reform look like?
- **OECD two-pillar approach (2020s):** What will it look like?
- **Next Congress:** What are the options?

Apportionment

- How do we divvy up corporate income when multiple jurisdictions are involved?
  - **Source-based:** where the economic activity was produced.
  - **Destination-based:** where the activity was consumed.
  - **Residence-based:** where the corporation is headquartered.
- How does the world today work?
  - Source-based is the most common system and tends to take precedence over the others.
  - Some countries, including the U.S., levy some additional residence-based taxes over the top on “their” companies.
  - Destination-based is situational. Countries might incorporate some destination-based principles to guard against profit shifting.

Profit Shifting

- Make a deductible payment from a high-tax jurisdiction to a low-tax jurisdiction.
  - Often easiest when "intangibles" (roughly, abstract factors of production like brands or patents) are involved.
  - Exploits source-based tax systems.
  - Countries sometimes compete on dimensions other than headline tax rate.
- Tactics also exist to exploit other tax systems.
  - Residence-based taxes are subject to inversions: use M&A to change residence to get out of residence-based taxes.
  - Destination-based taxes miss "quasi-exports" like hotels, struggle with e-commerce.

Goals of Multinational Tax Systems

- Raise revenue.
  - Protect domestic base from shifting.
  - Potentially add extra revenue on global income through residence-based taxation.
- Be an attractive place for global investment.
- Make your home-grown firms competitive abroad.
- Reduce complexity.

Tax Cuts and Jobs Act (2017):

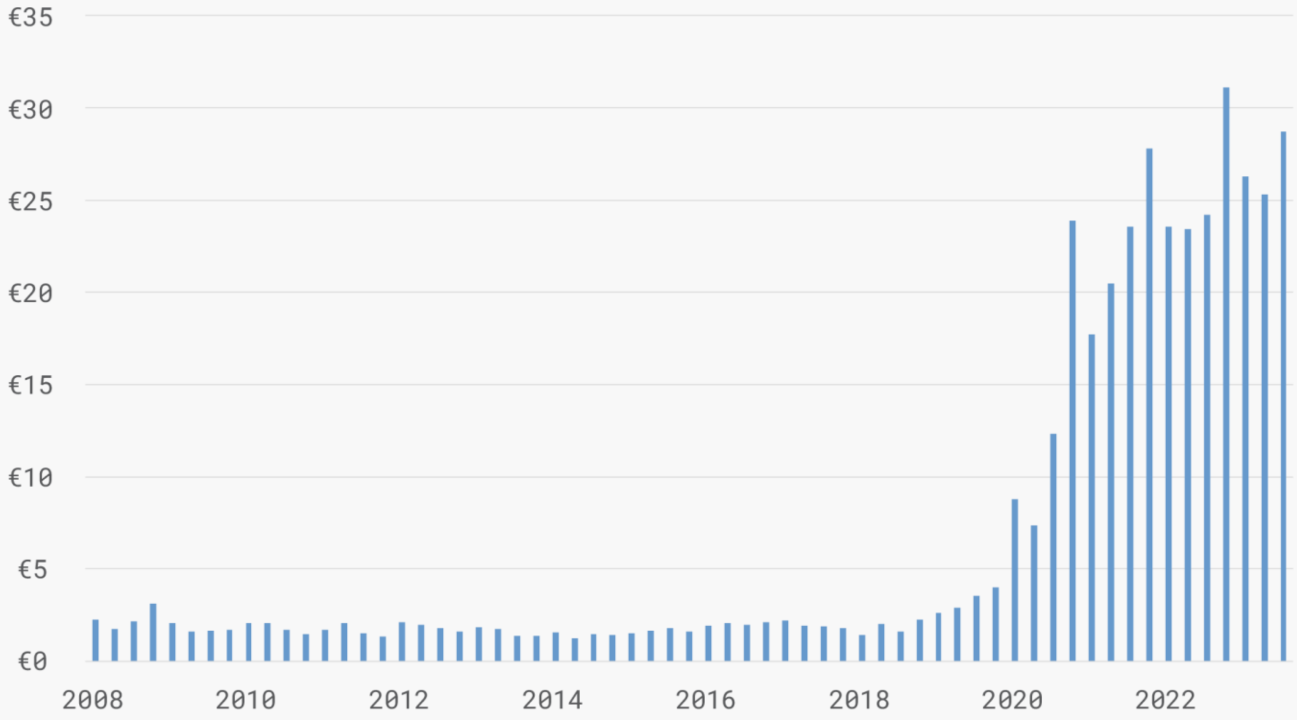
- Prior to TCJA, a 35 percent “worldwide” (residence-based) corporate income tax with unlimited deferral.
- Two problems:
  - Companies would “defer” as long as possible, leading to arguments over “money held overseas.”
  - Those companies that could not defer would invert to avoid the residence-based taxes.
- TCJA approach: reverse this entirely. Lower taxes on international income, but assess them immediately.

Tax Cuts and Jobs Act (2017):

- **Global intangible low-taxed income (GILTI):**
  - 10-13.125% rate. No deferral
  - Break for substantive operations, known as qualified basic asset investment.
  - Foreign tax credits
- **Foreign-derived intangible income (FDII):**
  - Partner to GILTI with similar attributes in terms of base and rate.
  - Applies to revenue derived from overseas but sourced to the U.S. for tax purposes.
  - Effectively, a low-rate “reward” for locating easily shiftable income in the U.S.
- **Base erosion and anti-abuse tax (BEAT):**
  - Limits “base erosion payments” as a share of deductions.
  - Effectively, statistical discrimination against a suspicious tax profile.

Intellectual Property Has Returned to the U.S. in Recent Years, Data from Ireland Shows

Ireland's Payments to United States for Use of Intellectual Property, 2008-2023 (Billions of Euros)



Source: European Statistical Office (Eurostat), "Balance of payments by country."

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OECD Two-Pillar Approach: Pillar One

- Tax large firms using destination-based principles: where are their customers located?
- Destination-based taxation can genuinely be superior against forms of profit shifting.
- However, a global shift to destination-based taxation, targeted specifically towards ultra-large firms, does not necessarily work to the advantage of the U.S. treasury.
- Could help forestall more haphazard "digital services taxes" that also tend to target U.S. firms.
- Negotiations stalled.

OECD Two-Pillar Approach: Pillar Two

- Global minimum tax rate of 15 percent.
- Enforced by cascading series of backstops:
  - **Qualified domestic minimum top-up tax (QDMTT)**, a source-based tax where the operations are happening.
  - **Income inclusion rule (IIR)**, the residence-based backstop assessed by the parent country.
  - **Undertaxed profits rule (UTPR)**, an extraterritorial tax.

Gaming Pillar Two

	Policy A	Policy B
Income before tax/subsidy	$1,000	$1,000
Tax (21%)	$210	$210
Tax credit	$80	-
Qualified refundable tax credit	-	$80
Cash flow	$870	$870
Income (Pillar 2)	$1000	$1080
Tax (Pillar 2)	$130	$210
Tax Rate (Pillar 2)	13.0%	19.4%
Penalty (Pillar 2)	$20	-

The Twin Risks of Pillar Two

Distributional Effects

- Ambiguous to U.S. Treasury
  - Foreign tax credits (-)
  - Profit shifting (+)
  - Lower shareholder taxes (-)
- Negative for U.S. taxpayers
- Opportunities for international reform

Fiscal Sovereignty

- Enforced through extraterritorial UTPR
- Foreign countries could tax U.S. earnings of U.S. firms
- U.S. unusually vulnerable
- Potential for workarounds

Next Congress:

- 2025-2026 likely time for tax reform
  - Address individual-side expiration of TCJA.
  - Address scheduled increases in TCJA international provisions (GILTI, BEAT)
  - UTPR likely to come into effect.
- Options:
  - Comply with Pillar Two or fight Pillar Two?
  - “Save” UTPR-vulnerable tax provisions?
  - Take advantage of reduced tax competition to increase rates?