



Budget Model

Incentives to Shift U.S. Multinational Profits to Foreign Countries under Tax Changes Proposed by House Ways and Means Committee

Summary: We project that recent tax reforms proposed by the House Ways and Means Committee would increase the incentive of U.S. firms to shift intangible investments and profits to foreign countries with a tax rate below 20.7 percent.

Key Points

- The House Ways and Means Committee reforms proposed as part of budget reconciliation would increase the tax rate differential between Foreign Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI) by between 1.5 percent and 7.6 percent.
- We estimate that these reforms would increase the incentive to shift intangible investments and profits recorded by U.S. firms to other countries with a tax rate below 20.7 percent.
- Firms with larger profits would have more incentive to absorb the costs of tax planning that are required to shift their profits.

Introduction

The Tax Cuts and Jobs Act of 2017 (TCJA) introduced the Global Intangible Low-Taxed Income (GILTI) regime to impose a minimum tax on multinationals' foreign income. It aims to capture income from intangible assets that is easy to shift to low-tax countries and apply a residual U.S. tax so that the total tax rate on GILTI is at least 10.5 percent. The regime allows a corporation to deduct 50 percent of its GILTI that otherwise faces the 21 percent statutory corporate rate, and 80 percent of foreign taxes paid on GILTI may be used as a foreign tax credit.

For example, the residual U.S. tax rate on income reported in a zero-tax foreign country is 10.5 percent ($21\% \times 50\%$). The total tax rate is therefore 10.5 percent since no foreign taxes are paid. For income that is subject to a 10

percent foreign tax rate, the residual U.S. tax rate is 2.5 percent ($21\% \times 50\% - 80\% \times 10\%$) and the total tax rate is 12.5 percent. For income facing a foreign tax rate of 13.125 percent or higher, the residual U.S. tax rate is zero, and as a result, the total tax rate equals the foreign tax rate. Figure 1 shows the total tax rate on GILTI as foreign tax rate rises under current law.

The TCJA also introduced a preferential tax rate on a corporation's Foreign Derived Intangible Income (FDII), which depends on its domestic income derived from foreign use. It aims to encourage multinationals to locate their intangible income in the U.S. by taxing it at a lower rate of 13.125 percent through a 37.5 percent deduction.

Both GILTI and FDII are determined by excluding a 10 percent deemed return on tangible assets. Location of tangible investment such as factories is less responsive to tax rates and depends on factors such as proximity to consumers and the availability of other cheaper or better-quality inputs. Intangible assets, on the other hand, are much more mobile and easily affected by tax rates.

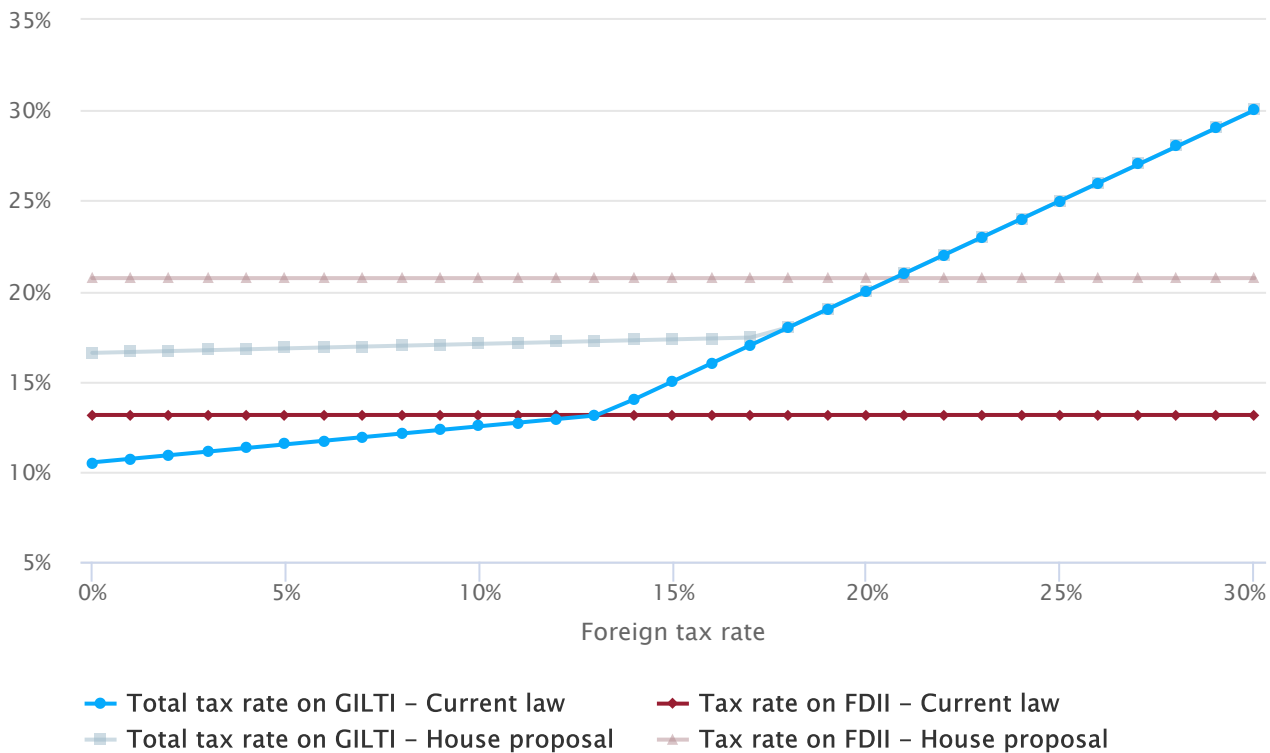
For foreign-earned income that is generated by an intangible investment, a U.S. multinational faces two different tax regimes. If the investment is located in the U.S., the income is subject to the FDII tax rate. If the investment is located abroad, then the income faces the GILTI tax rate.

Current Law

Figure 1 shows that under current law, income from the intangible investment faces a lower tax rate if it is in a foreign country with a tax rate lower than 13.125 percent than in the U.S. That is, the multinational finds it tax advantageous to shift intangible assets and the profits they generate to a low-tax country with a tax rate below 13.125 percent. A foreign country with a tax rate above 13.125 percent is less desirable than the U.S. given the reduced rate on FDII.

Figure 1: Tax Rate on GILTI versus FDII under Current Law

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Notes: The grayed out series show the tax rate on GILTI versus FDII under The House Ways and Means Committee proposal for easy comparison.

House Ways and Means Committee Proposal

Proposed changes by The House Ways and Means Committee would¹

- increase the statutory corporate rate from 21 percent to 26.5 percent;
- lower the GILTI deduction to 37.5 percent and the FDII deduction to 21.875 percent beginning in 2022 instead of 2026 as under current law;
- increase the deemed paid tax credit from 80 percent of the foreign taxes paid on GILTI to 95 percent.

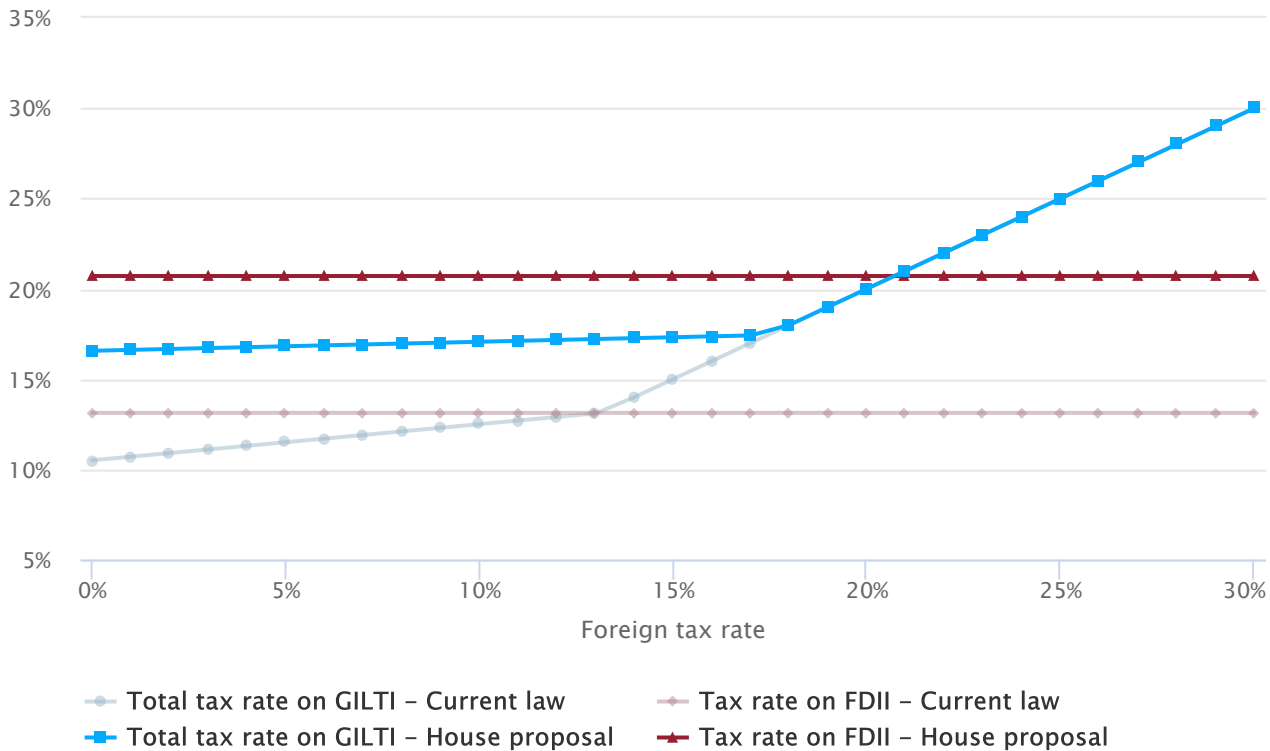
Figure 2 shows the total tax rate on GILTI as foreign tax rate rises under the House proposal.

For income reported in a foreign country with a zero tax rate, the residual U.S. tax rate would be 16.6 percent (26.5% x 62.5%). The residual U.S. tax rate on income reported in a foreign country with a 10 percent tax rate would be 7.1 percent (26.5% x 62.5% - 95% x 10%) and the total tax rate would be 17.1 percent. The residual U.S. tax rate would be zero for income that is subject to a foreign tax rate of 17.4 percent or higher. The lower deduction on FDII coupled with the higher statutory corporate rate brings the tax rate on FDII to 20.7 percent.

Under the House proposal, a multinational could lower its taxes if it locates intangible assets and the income they generate in a foreign country with a tax rate below 20.7 percent. A foreign country that is less tax advantageous than the U.S. as a destination for its intangible investment under current law could become more attractive under the House proposal.

Figure 2: Tax Rate on GILTI versus FDII under House Proposal

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Notes: The grayed out series show the tax rate on GILTI versus FDII under current law for easy comparison.

Figure 3 shows the tax rate *differentials* between FDII and GILTI as a function of the foreign tax under current law and the House proposal. When the rate differential is above zero, income from intangible investment faces a higher tax rate in the U.S. than abroad.

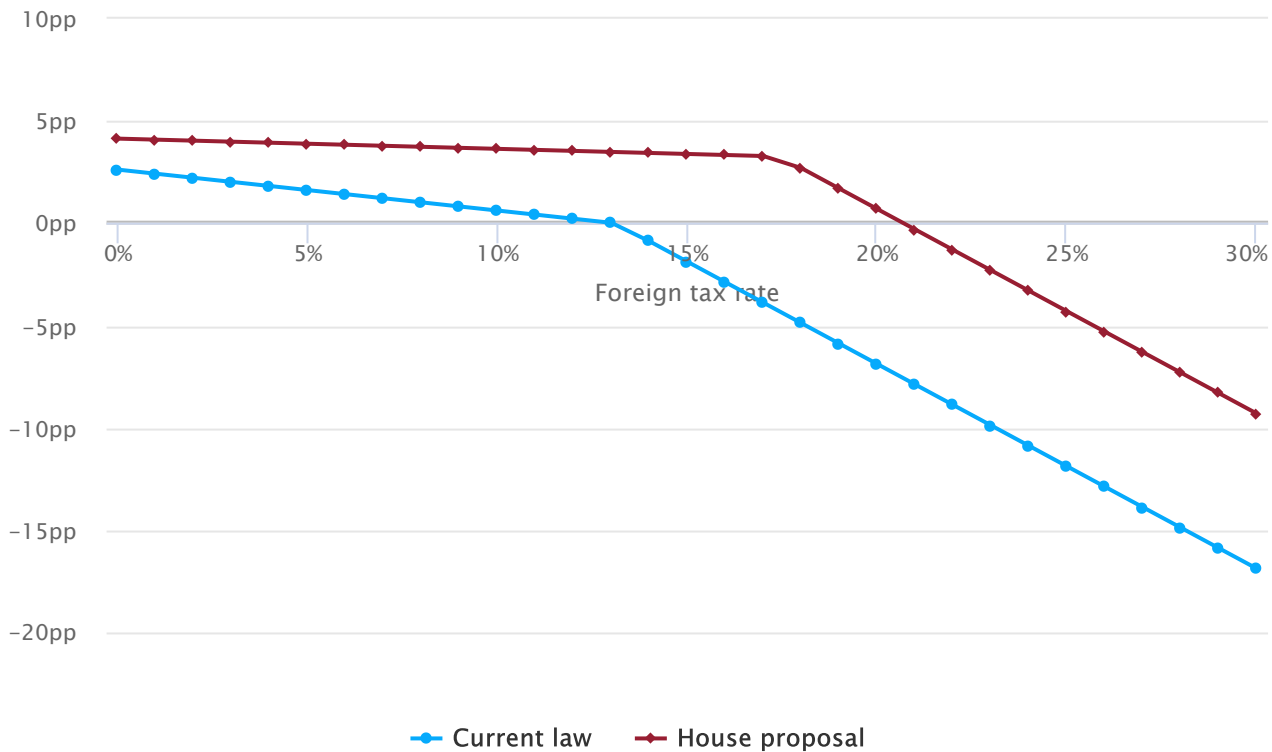
The House proposal increases the “zero differential threshold” from 13.125 percent under current law to 20.7 percent. Hence, more foreign countries---those with tax rates between 13.125 percent and 20.7 percent---would become more attractive for profit shifting. The tax rate differential also increases as follows:

- Under the House proposal, the tax rate differential would be 1.5 to 3.5 percentage points higher than under current law when the foreign country has a tax rate under 13.125 percent. That is, the income would face an even higher rate in the U.S. relative to the foreign country, although the change is moderate given that both FDII and GILTI rates would go up under the proposal.

- The tax rate differential would go up by between 3.5 and 7.6 percentage points when the foreign country has a tax rate between 13.125 percent and 20.7 percent under the House proposal. This differential increase would make the foreign country more tax advantageous for the multinational’s intangible investment.
- Under the House proposal, the tax rate differential would increase by 7.6 percentage points when the foreign country has a tax rate above 20.7 percent since the FDII rate would be 7.6 percentage points higher. The income would still face a lower rate in the U.S. relative to the foreign country, but the difference would narrow compared to under current law.

Figure 3: Tax Rate Differential between FDII and GILTI

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Putting these pieces together, the U.S. would become an even more tax-disadvantaged location for a multinational’s intangible investment compared to a foreign country with a tax rate below 20.7 percent under the House proposal. The U.S. would still be more tax-advantaged compared to a foreign country with a tax rate over 20.7 percent, but that tax advantage would shrink.

Whether these widened tax rate differentials provide enough incentive for multinationals to shift their intangible assets abroad depends on the costs of setting up complex tax planning structures and sometimes relocating real economic activities to comply with economic substance requirements.

This analysis was conducted by [Alexander Arnon](#) and [Zheli He](#). Prepared for the website by [Mariko Paulson](#).

1. There are a few other changes that would considerably affect the effective residual U.S. tax rate on GILTI. They would not be reflected in this analysis which only considers the statutory tax rates. These changes include the determination of foreign tax credits and GILTI inclusion on a country-by-country basis; limiting carryforward of excess foreign tax credits from 10 to 5 years; lowering the substance carve-out for tangible assets from 10 percent to 5 percent; allowing for carryover of foreign losses and excess foreign tax credits to subsequent years and the inclusion of foreign oil and gas extraction income in GILTI. ↩