Higher GILTI Taxes Would Help Foreign Competitors and Hurt U.S. Jobs

Extended Background and Explanation of GILTI

President Biden during his campaign proposed to increase the tax rate of the foreign minimum tax (global intangible low-taxed income, "GILTI") to 21% from 10.5% along with other changes to GILTI that would increase the tax burden on U.S. companies.

BACKGROUND

- The U.S. minimum tax on the foreign earnings of U.S. companies – global intangible low-taxed income ("GILTI") – was enacted as part of the international tax changes included in the 2017 tax law. Earlier versions of a U.S. minimum tax had been proposed by the Obama Administration in its FY 2016 and FY 2017 budget proposals.

- A key goal of the 2017 tax law was to improve U.S. competitiveness and make taxes a neutral factor in the decision to invest in the U.S. or abroad. As described below, there were a number of provisions of prior law that harmed the ability of U.S. companies to compete in global markets.

- Prior to 2018, the United States generally taxed active foreign business income of U.S. companies only when remitted to the U.S. parent as a dividend. In contrast, most other developed countries (30 of the other 36 OECD countries, and all other G-7 countries) have territorial systems that exempt from tax 95%-100% of foreign dividends. As a result, foreign earnings of a company headquartered in a territorial country were effectively subject to tax only in the country where earned, while foreign earnings remitted to a U.S. parent incurred both foreign country tax and additional U.S. tax. The additional U.S. tax was calculated after applying a tax credit for foreign taxes, but because the United States had the highest tax rate among developed countries, the additional U.S. tax on foreign earnings could still be substantial.

- The extent of this tax disadvantage for U.S. companies became increasingly apparent over time:
    - » First, because remitted foreign earnings could bear up to an additional 35% U.S. tax, U.S. companies had an incentive to leave their foreign earnings overseas. Foreign earnings were said to be "locked out" of the United States by this high rate of tax. The penalty for bringing foreign earnings back to the United States could equivalently be viewed as providing a tax credit of up to 35% to keep foreign earnings abroad. In 2016, the Joint Committee on Taxation estimated U.S. companies held $2.6 trillion in unremitted foreign earnings.[1]

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1. Letter from Joint Committee on Taxation Chief of Staff Thomas A. Barthold to Chairman Kevin Brady and Ranking Member Richard Neal, August 31, 2016.

- Second, because U.S. companies could not remit foreign earnings to the U.S. without incurring additional tax, a foreign subsidiary was less valuable when owned by a U.S. company than when owned by a foreign-headquartered company that could access these earnings without paying additional home country tax. As a result, a U.S. company wishing to support domestic employment through the acquisition of a foreign company would not be able to offer as much to acquire the foreign company than a foreign multinational bidding on the same target. As a result, U.S. companies were often losing out in these M&A transactions.
- Third, the tax disadvantage in accessing foreign earnings often made U.S. companies attractive targets to foreign multinational companies. Once acquired by a foreign company, the future growth in foreign earnings of the former U.S. company could be accessed by the foreign multinational company without bearing an additional tax, whereas if owned by a U.S. company the remitted foreign earnings would face a substantial additional U.S. tax.
- Fourth, this tax disadvantage led some U.S. companies to pursue mergers with smaller foreign companies and, after the merger, reincorporate as a foreign-domiciled company. These transactions were often referred to as "inversions." The Congressional Budget Office identified planned inversion transactions of $319 billion in 2014, a sum greater than all inversion transactions completed in the prior 30 years.[2] While Treasury regulations announced in 2014 caused some of these transactions to be withdrawn, they did not address the underlying tax disadvantage faced by U.S. companies but rather just stranded U.S. employers in an uncompetitive system. Mergers of equal sized companies were not affected by the Treasury regulations; nor could regulations address the formation of new entities abroad rather than in the United States.
- With an increasing number of companies that would otherwise have been U.S. companies being headquartered abroad, concerns increased that in addition to the loss of well-paying headquarters jobs – including operations, finance, and research – manufacturing and other production jobs would move as well, and the companies would then also increasingly become reliant on foreign suppliers rather than U.S. companies for their purchases of supplies.

• It became evident to many policymakers that the U.S. tax system was harming the ability of U.S. companies to compete globally. Because expansion by U.S. companies in foreign markets supports domestic employment, a reduced ability to compete in foreign markets results in fewer jobs at home.[3]

- This complementary linkage between the foreign employment of a U.S. company and its domestic employment is significant. A 10% increase in a U.S. company's foreign employment has been estimated to lead to a 6.5% increase in the company's U.S. employment.[4]
- Likewise, a 10% decrease in a U.S. company's foreign employment may lead to a 6.5% decrease in the company's U.S. employment. Given that U.S. multinational companies employ twice as many workers

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2. Congressional Budget Office, *An Analysis of Corporate Inversions*, September 2017.

3. Desai, Mihir A., C. Fritz Foley and James R. Hines, Jr. 2009. "Domestic Effects of the Foreign Activities of U.S. Multinationals." *American Economic Journal: Economic Policy*, 1(1):181-203.

4. Ibid.

in the United States than they do abroad,[5] this implies that for every 100 jobs lost abroad, their U.S. employment may decline by 130 jobs.

THE NEW U.S. INTERNATIONAL TAX RULES: GILTI EXPLAINED

- The 2017 tax law made several changes to the treatment of cross border income that were intended to address the problems of prior law.
  1. All foreign active business income became subject to a minimum rate of U.S. and foreign tax when earned (GILTI), rather than when remitted to the U.S. parent as a dividend. The minimum rate of tax was established to reduce the anti-competitive features of prior law that disadvantaged U.S. companies in foreign markets while at the same time providing a guardrail to protect the U.S. tax base against tax motivated incentives to shift profits to low-tax jurisdictions.

     The new law also established the Base Erosion and Anti-Abuse Tax (BEAT) to apply a surtax on certain otherwise deductible payments between a U.S. company and its foreign affiliates.
  2. A reduced U.S. tax rate comparable to GILTI was established for certain domestic income earned on sales of goods and services to foreign customers (foreign derived intangible income, "FDII").
  3. To address foreign income earned prior to the implementation of the new rules, a transition tax was applied to foreign earnings that had not previously been subject to U.S. tax, regardless of whether those earnings were repatriated or remained reinvested overseas.

  The summary below focuses on the new rules for GILTI and FDII.

- First, the tax law created a new category of taxable income – GILTI – comprised of all foreign active business income of a U.S. company, less certain deductions.
  - » GILTI is calculated on an aggregate basis across all foreign active business income in all countries.
  - » A deduction equal to 10 percent of depreciable foreign property (qualified business asset investment, "QBAI") is permitted. Certain foreign interest expense reduces the amount of this deduction. The deduction is intended to exempt from U.S. tax a routine return on income earned from the ownership and operation of certain tangible property.
  - » After including GILTI in U.S. taxable income, a new Section 250 deduction for 50-percent of GILTI is permitted (this deduction is reduced to 37.5-percent after 2025).
  - » The effect of the deduction for a U.S. company with positive domestic income is to tax GILTI at half the 21% U.S. corporate tax rate, 10.5%. (After 2025, the reduction in the deduction to 37.5 percent results in a 13.125% tax on GILTI.)
  - » A company is permitted a foreign tax credit against U.S. tax on this income, but no more than 80 percent of foreign taxes are eligible to be included in the foreign tax credit computation. With only 80 percent of foreign taxes creditable, GILTI must bear foreign taxes at a rate of at least 13.125% in order

5. Bureau of Economic Analysis, "Activities of U.S. Multinational Enterprises, 2018," August 2018.

for no additional U.S. tax to be owed (since 80% of 13.125% is equal to the 10.5% U.S. tax rate on GILTI). After 2025, foreign taxes must exceed a rate of 16.4% for no additional U.S. tax to be owed.

- ◊ Treasury regulations provide that the foreign tax credit calculation for GILTI follow prior-law U.S. rules that require certain U.S. expenses, such as interest and stewardship, to be allocated against foreign income in determining the foreign tax credit. This expense allocation requirement reduces the foreign tax credit a company is permitted to claim when U.S. tax on GILTI net of the Section 250 deduction and net of allocated expenses is less than 80 percent of foreign taxes. The appendix provides an example of expense allocation limiting the foreign tax credit.
- ◊ Companies with relatively high foreign effective tax rates on GILTI (e.g., rates in excess of the 21% U.S. tax rate) can be subject to additional U.S. tax on their GILTI due to these expense allocation rules. Because GILTI was intended to ensure that the foreign income of U.S. taxpayers is subject to a minimum foreign rate of taxation, regulations provide taxpayers the ability to elect a "high-tax exclusion" for income that is taxed at a rate of at least 18.9%, which is 90 percent of the U.S. rate (90% of 21%). Due to various restrictions on the election, not all taxpayers with foreign income taxed in excess of 18.9% will make the election. As a result, additional U.S. tax may be owed on GILTI even when taxed by foreign countries at rates that exceed 18.9%, and because no election is provided for foreign tax rates below 18.9%, frequently for U.S. taxpayers with foreign rates of tax between 13.125% and 18.9%.

- Second, the tax law created a favorably taxed category of domestic income to remove the prior-law tax bias against the ownership of intangible assets in the United States. FDII largely parallels GILTI, but it applies to domestic income.
  - » FDII consists of income derived from the sale or licensing of goods and services to foreign customers earned from the United States, less a deduction of 10-percent of depreciable property (QBAI). The deduction for QBAI is similar to that applying to GILTI, and results in the FDII benefit being limited to income earned in excess of a routine return on tangible property.
  - » A deduction is provided for 37.5 percent of FDII, which for a U.S. company with positive domestic income, effectively reduces the tax rate on FDII to 13.125%. (The deduction is reduced to 21.875 percent for years after 2025, causing the effective tax rate on FDII to rise to 16.4%.) These deduction percentages are similar to those under GILTI after accounting for the fact that U.S. tax on GILTI cannot be offset by more than 80 percent of foreign taxes.

- In summary, GILTI ensures that income earned on intangible assets owned abroad is subject to a minimum foreign and U.S. tax rate of between 10.5% and 13.125% (or higher, given expense allocation rules), while FDII encourages ownership of these assets in the United States by providing a comparable U.S. tax rate.

- The net effect of the 2017 law was assessed by the Joint Committee on Taxation at the time of its enactment to result in an "increase in investment in the United States, both as a result of the proposals directly affecting

taxation of foreign source income of U.S. multinational corporations, and from the reduction in the after-tax cost of capital in the United States due to more general reductions in taxes on business income." [6]

BIDEN CAMPAIGN PROPOSAL TO RAISE THE GILTI TAX RATE

- President Biden proposed during his campaign to increase the GILTI minimum tax rate on foreign income to 21%. Because only 80 percent of foreign taxes may be taken into account when determining the GILTI foreign tax credit, the end result is that a U.S. company would owe minimum tax to the U.S. if it paid foreign taxes of less than 26.25%.[7] Further, due to expense allocation rules that result in incomplete crediting of foreign taxes, a U.S. company could owe minimum tax even when it paid foreign taxes in excess of 26.25%. Because no other country in the world has a GILTI type regime, raising the GILTI rate would have adverse consequences for U.S. companies competing in foreign markets and the U.S. jobs that support these activities.
    - Secretary Yellen has acknowledged the current law GILTI is more rigorous than that of other countries as "most other headquarters' jurisdictions impose no tax on the foreign earnings of their domestically-headquartered multinationals." [8]
    - Subjecting U.S. companies to far higher levels of tax than their foreign-owned competitors (which are not subject to any similar minimum tax) would reduce U.S. headquarters jobs, U.S. investment, and U.S. R&D because the domestic activities of U.S. multinationals are complementary with their foreign operations.[9]

- Another concern is that raising the GILTI rate would reinstate the problem of U.S. companies being taken over by foreign companies. Because only U.S.-owned companies – and not foreign-owned companies – are subject to the additional (higher) GILTI tax, the foreign operations of U.S. companies would be more valuable when owned by foreign companies. Consequently, U.S. multinationals or their foreign subsidiaries would likely become acquisition targets of foreign competitors, and innovative new companies would incorporate outside the United States.
    - This is not speculation. Prior to the 2017 law, U.S. assets and U.S. companies were being acquired by foreign companies headquartered in territorial countries with more favorable international tax rules. Other U.S. companies left the United States through friendly mergers so that they could better compete against other foreign multinationals.

- GILTI already serves as a rigorous minimum tax on foreign income. Any increases in the GILTI tax burden must recognize the competitive effects on U.S. companies competing in global markets and the adverse consequences on the U.S. economy from the loss of U.S. jobs if their competitiveness is diminished.

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6. Joint Committee on Taxation, *Macroeconomic Analysis of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act"*, JCX-69-17, Dec. 12, 2017, p. 7

7. The GILTI rate would be increased to 21% so that, combined with the credit for 80% of foreign taxes, foreign income subject to a tax rate of less than 26.25% would be subject to GILTI (80% of 26.25% is equal to 21%).

8. Response to Sen. Finance Committee, "Follow-up Questions for the Record for Hon. Janet L. Yellen," Jan. 22, 2021.

9.Desai, Mihir A., C. Fritz Foley and James R. Hines, Jr. 2009. "Domestic Effects of the Foreign Activities of U.S. Multinationals." *American Economic Journal: Economic Policy*, 1(1):181-203.

BIDEN CAMPAIGN PROPOSAL TO MODIFY GILTI TO A PER-COUNTRY CALCULATION

- President Biden also proposed during his campaign to increase the tax burden on GILTI by determining the foreign minimum tax separately for each country rather than on an aggregate basis across all foreign countries.

- Determining GILTI on a per-country basis would impose heavy compliance and administrative costs, disregard the integrated nature of multinational business operations, and create inequities among U.S. companies that pay the same overall foreign tax rate but operate in different countries.

- The aggregate, worldwide approach of GILTI is designed to promote fairness between companies and to minimize complexity. Under a per-country calculation, companies that pay the same overall foreign tax rate on their foreign operations could owe different amounts of GILTI if their supply chains differed, violating principles of fairness. Under the GILTI regime, by contrast, two companies that face the same overall foreign tax burden will face the same incremental GILTI tax.

- In addition, although GILTI does permit computation of foreign tax credits on a global basis, it is limited to a single year's "snapshot" of foreign tax, with no carryover or carryback of excess foreign tax credits or other form of multi-year averaging. Stated differently, GILTI provides for averaging of foreign taxes across countries within a single year but does not provide any form of averaging over multiple years. To properly measure a company's tax burden within each country, including the impact of timing differences between that particular country's law and U.S. law, a per-country approach would need to compute taxes on a multi-year basis. Failing to do so would inevitably result in significant double taxation by imposing U.S. tax on foreign earnings that, over multiple years, were subjected to high foreign tax within a country.

- A per-country approach would also increase the number of foreign tax credit "baskets" from the four baskets provided under current law to more than 100 for many companies (one for each country in which a company does business). Congress repealed a per-country limitation on the foreign tax credit in 1976, in part due to complexity. Since 1976, the number of globally-engaged U.S. companies and the number of countries in which they do business have both expanded dramatically.

- Finally, under a per-country minimum tax, a low-tax country would have a strong incentive to raise its tax rate to the minimum tax rate and could offer incentives to foreign investors other than income tax reductions. This could make the foreign country even more attractive from an investment perspective, and independent of any increase in investment, could reduce U.S. tax revenue.

- While the OECD is currently discussing a blueprint for a global minimum tax that would be applied on a per-country basis, the OECD discussions assume a low rate (likely 12.5%), no requirement for expense allocation, a complete offset for foreign taxes paid rather than the 80% under GILTI, a carry-forward of losses and excess taxes to provide a form of multi-year averaging not available under GILTI, and a more generous carve out for routine returns than GILTI.

  - Given these important structural differences, the OECD Secretariat has determined that GILTI imposes a larger tax burden in most cases than the OECD blueprint for a global minimum tax.
  - If the U.S. were to further increase the GILTI tax burden – especially before adoption by competitor countries of any form of foreign minimum tax – the magnitude of the competitive disadvantage to U.S. companies would become even more severe.

BIDEN CAMPAIGN PROPOSAL TO MODIFY GILTI TO REPEAL QBAI

- A third change to GILTI proposed by President Biden during his campaign is to eliminate the deduction for routine returns.

- Eliminating the deduction for routine returns on investments in plant and equipment (QBAI return) is inconsistent with the goal of GILTI, i.e., to impose tax on highly mobile income, particularly returns to intangible property, and would reduce the ability of U.S. companies to compete abroad.
  - GILTI was intended to eliminate incentives to move intangible income to low-tax jurisdictions while recognizing that U.S. businesses operate abroad principally to serve foreign markets.
  - Imposing U.S. tax on the ordinary, routine return of a foreign facility – be it a mine, a local factory, a retail store, or hotel – would disadvantage U.S. ownership of the facility over a company headquartered anywhere else in the world.
  - The Obama Administration recognized the need to have an exemption for routine returns and included a similar exemption in its proposed minimum tax.
  - The OECD blueprint for a global minimum tax also proposes an exclusion similar to but broader than QBAI. In addition to excluding a return on depreciable property, the OECD proposal also excludes includes a return on other types of property (land, natural resources, and leased assets) and on a percentage of payroll.

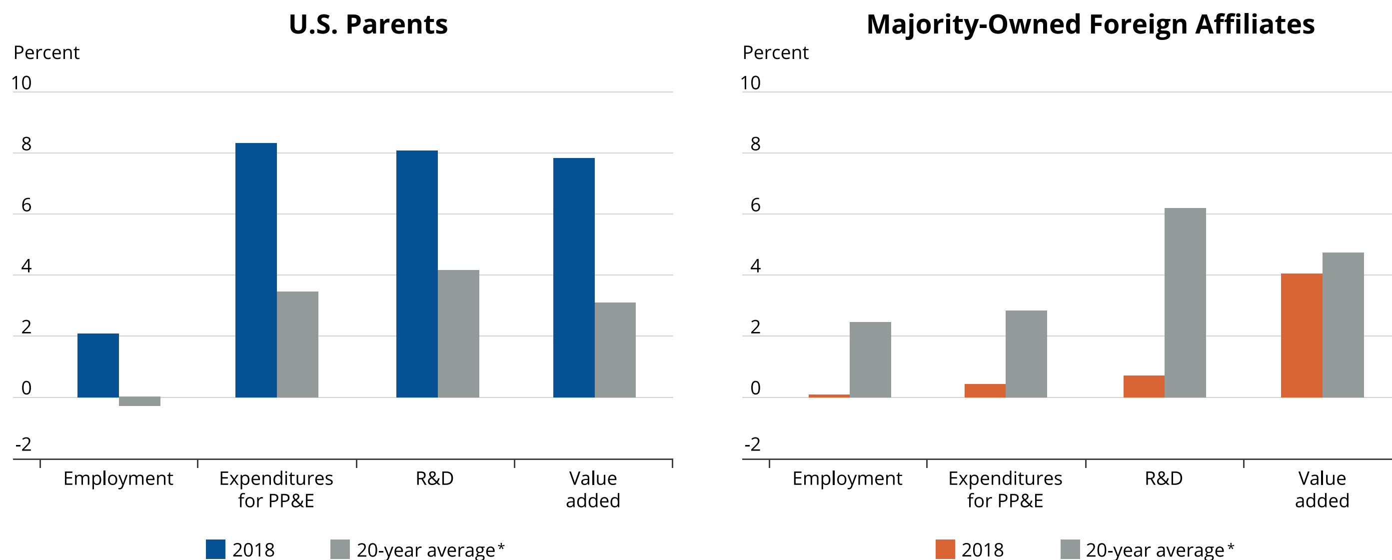
PROPOSALS TO INCREASE THE TAX BURDEN ON THE FOREIGN EARNINGS OF U.S. COMPANIES ARE MISPLACED

- The Biden campaign proposals are apparently based on the mistaken belief that the 2017 law created an incentive to move jobs offshore. However, the most recent government data for 2018, the first year the new law was in effect, show the opposite: (1) employment, value added, and investment in plant and equipment of U.S. multinational companies grew faster in the U.S. than abroad; (2) the growth in the U.S. of these activities exceeded their 20-year averages; and (3) the growth abroad in these activities was below their 20-year averages (see Figure 1). [10]

10. U.S. Bureau of Economic Analysis, “Activities of U.S. Multinational Enterprises, 2018,” Press Release, BEA 20-40, Aug. 21, 2020.

FIGURE 1

Annual Percentage Change in the Activities of U.S. Multinational Companies



*20-year average, 1998-2018, excluding benchmark years (1999, 2004, 2009, and 2014).

U.S. Bureau of Economic Analysis, "Activities of U.S. Multinational Enterprises, 2018," Press Release, BEA 20-40, Aug. 21, 2020.

- U.S. government data show that nearly 90% of the sales of goods and services by the foreign subsidiaries of U.S. companies are to foreign customers. Increasing U.S. tax on these operations will make U.S. companies less competitive in the global marketplace and reduce their global market share.
    - » If U.S. companies' operations in foreign markets shrink, they also risk job losses at home as the jobs that support those foreign activities are cut and the U.S. domestic market faces import competition from stronger foreign-owned companies.
- Experience shows that taxing the foreign operations of U.S. companies at rates above those faced by foreign competitors will come at the cost of U.S. global market share and U.S. jobs.
    - » Legislation in 1975 and 1986 increased taxes on the foreign income of the U.S. shipping industry to rates far higher than those paid by foreign competitors. As a result, the U.S. shipping industry shrank precipitously, while foreign shippers expanded. Only after 2004 legislation reversed these earlier measures did the U.S. shipping industry again begin to expand.

APPENDIX – EXAMPLE OF EXPENSE ALLOCATION IMPACT ON GILTI

The following example shows the effect of expense allocation for a U.S. company under GILTI. The U.S. company in this example has one foreign affiliate with pre-tax GILTI of $1,000 and pays foreign tax of $180 at a foreign tax rate of 18%.[11] Because the foreign tax rate does not exceed 18.9%, the company is unable to elect the high-tax exclusion on this income.

After the 50-percent Section 250 deduction, the U.S. company has $500 subject to U.S. tax (50% of $1,000) and the U.S. tax before foreign tax credit on this income is $105 (21% of $500). As only 80 percent of foreign taxes on GILTI are taken into account, creditable foreign taxes are $144 (80 percent of $180). Absent the expense allocation regulations, the U.S. company would owe no additional U.S. tax on GILTI, because creditable foreign taxes ($144) are greater than U.S. tax before credits ($105).

In practice, the U.S. company may owe additional U.S. tax on GILTI because regulations require U.S. expenses to be taken into account in determining the foreign tax credit limitation. In the example below, $200 of U.S. expenses are assumed to be allocable to foreign income in determining the foreign tax credit limitation. In this case, the foreign tax credit limitation is reduced from $105 (21% of $500 of GILTI after the Section 250 deduction) to $63 (21% of $300, which is $500 less the $200 of allocable expenses). As a result, the foreign tax credit is reduced to $63, and the U.S. company pays additional U.S. tax of $42 ($105 less the $63 allowed foreign tax credit).

Consequently, the U.S. company pays total foreign and U.S. tax on its foreign income of $222 ($180 of foreign tax plus $42 of U.S. tax), for a total effective tax rate on the foreign income of 22.2% ($222 divided by $1,000 of foreign income).

In this example, not only do the expense allocation results result in the U.S. company paying additional tax on GILTI even though the foreign income is taxed at a rate in excess of 13.125%, it results in a total tax burden on this income in excess of the U.S. 21% corporate tax rate.

IMPACT OF EXPENSE ALLOCATION ON GILTI

[Example with $200 of domestic expenses allocable to GILTI]

LINE	ITEM	FORMULA	AMOUNTS
A	Foreign tax rate	Assumed	18.0 %
B	Pre-tax GILTI	Assumed	$1,000
C	Taxable GILTI after 50% sec. 250 deduction	50% x B	$500
D	Tentative U.S. tax (before foreign tax credit) at 21% corporate rate	21% x C	$105
E	Foreign tax paid	A x B	$180
F	Foreign taxes eligible for credit	80% x E	$144
G	Domestic expenses allocated to foreign income	Assumed	$200
H	Foreign tax credit allowed	21% x (C - G)	$63
I	U.S. tax credit allowed	Lesser of F and H	$63
J	U.S. tax on GILTI after foreign tax credit	D - I	$42
K	Combined U.S. and foreign tax paid	E + J	$222
L	Combined U.S. and foreign tax rate on GILTI	K / B	22.2%

11. To simplify the example, no QBAI deduction is shown in deriving pre-tax GILTI.