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Bold International Tax Reforms to Counteract the OECD Global Tax

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EXECUTIVE SUMMARY

Nearly 140 countries, including the United States, have endorsed a new global tax system proposed by the Organisation for Economic Co-operation and Development (OECD). This proposal, which aims to increase global business taxes and targets America's most successful companies, threatens to undermine crucial features of the international corporate tax system. Congress will face a decision in 2025: conform to the OECD's system or opt out and safeguard America's position as the most attractive place to do business.

The taxation of multinational businesses often raises concerns about a "race to the bottom" through harmful tax competition and businesses shifting profits to low-tax countries. Yet the magnitude and effect of these two phenomena are commonly misunderstood. Tax competition has allowed average statutory corporate tax rates to be cut in half over the past four decades, fueling investment and economic growth. Among OECD countries, revenues have increased while tax rates declined.

The magnitude of profits shifted to low-tax countries is often inflated by researchers relying on data that overstate income in tax havens. A more comprehensive picture shows that about 8 percent of US corporate profits are reported in tax havens, only half of US multinationals have any presence in a tax haven, and they face higher effective tax rates than domestic competitors. Where it does exist, profit shifting acts as a tax cut on investment, boosting jobs and economic growth in both tax havens and higher-tax home markets.

Following the long history of costly reforms to stop businesses from moving profits overseas, US policymakers should try a different approach. Instead of enacting new rules to stop income shifting out of the United States, Congress should focus exclusively on increasing the attractiveness of the United States as an investment destination.

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INTRODUCTION

American international tax policy is at a crossroads. Following more than two decades of international debate over how to rewrite the taxation of multinational businesses, nearly 140 countries, including the United States under the Biden administration, have agreed to a new global tax system.[1] Coordinated by the Organisation for Economic Co-operation and Development (OECD), this proposal seeks to increase global business taxes and risks undermining one of the most valuable features of the international corporate tax system—diversity and competition.

Over the next two years, before Americans face broad-based automatic tax increases from the expiration of the 2017 tax cuts, Congress will have to choose to either capitulate to the OECD's new global tax system or opt out and safeguard America's position as the most attractive place in the world to do business. Doing nothing would result in lost tax revenue and automatic tax increases on US multinational businesses that would leave them with a uniquely complex and costly tax system.

Former members of President Biden's administration argue that the OECD's global tax initiative offers a technocratic solution for a broken international tax system that will increase efficient and fair tax collections.[2] However, the OECD's most recent proposal is better understood as another step toward establishing an international tax cartel intent on collecting ever more tax revenue while allowing less and less autonomy for independent countries to set their own tax rules. The OECD proposal is largely motivated by anti-American populist politics.[3] The rules are designed to target American firms, selectively carving out certain industries and businesses below arbitrary thresholds. Moving forward with the OECD's proposal—either with or without the United States—would primarily hurt the economies of countries implementing the new taxes by increasing the costs of locating domestically.

Corporate tax codes attempt to perform an impossible task at a high cost to investment, jobs, and economic growth. Corporate income taxes collect revenue from sprawling international business networks that span dozens of countries, each with distinct rules governing what is subject to tax and where. These cross-border tax rules prop up a system designed for a 20th-century world with limited global trade and investments largely in physical assets, rather than across intangible global value chains. Short of repealing the corporate income tax and relying on more stable and less costly revenue streams, Congress can work to reduce the US corporate tax burden by rejecting the OECD proposals and streamlining US international tax rules.

This policy analysis begins by describing the main features of international corporate income tax systems and their history. This history is a tug of war between reforms advanced by countries seeking to attract business investment and proposals—from both the OECD and individual countries—designed to limit multinational tax planning. It has resulted in countries moving away from worldwide tax rules and reducing average statutory tax rates by half over the last 40 years. Falling corporate tax rates often precipitate fears of a "race to the bottom." However, as corporate tax *rates* fell, corporate tax *revenues* across the OECD countries increased.[4]

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Policymakers often also worry about multinational profit shifting—whereby firms overreport taxable income in low-tax countries. Adjusting for data that overstate income in tax havens, measured corporate profits in tax havens amount to about 8 percent of total US corporate profits (compared to the often-cited 65 percent tax havens' share of US foreign profits).[5] Moreover, less than half of multinationals have any presence in tax havens.[6] Multinationals also tend to face higher effective tax rates than domestic competitors.[7] That means that multinationals do not take full advantage of opportunities for profit shifting.

Instead of repeating the mistakes of past reforms and enacting new rules to stop income shifting out of the United States, Congress should focus on increasing the attractiveness of the United States as an investment destination. To achieve this, Congress should lower the United States' above-average corporate income tax rate, eliminate the arbitrary limits on tax write-offs for research and development (R&D) spending, make expiring full-expensing provisions for domestic investments permanent, and reform hopelessly complex US cross-border tax rules.

The final section of this paper outlines how fixing each of these items would help Congress meet two goals simultaneously. First, it would support American workers and investors by making America the most attractive place in the world to do business. Second, it would undermine the OECD global tax increase by opting out of its tax cartel, lowering the risk that the project moves forward as currently conceived.

OVERVIEW OF INTERNATIONAL TAXATION

Corporate tax codes set forth rules to collect taxes from sprawling business networks spanning almost 200 countries, each with different tax rules. This task breeds exceptional complexity.

Imagine a multinational technology manufacturer that designs its products in the United States, where labor is expensive but highly educated, and manufactures its products in Vietnam, where labor is inexpensive. It sells these products primarily in high-demand markets in the United States and Europe and holds its intellectual property in Ireland. Rules spanning multiple countries must ultimately source this firm's income to specific locations, where it is then subject to tax.

However, the current patchwork of international tax rules also allows for strategic business decisions and competition between nations for multinational companies' highly mobile financial income and physical investments.

This section will review the key components of the international tax system, starting with the corporate tax as a mechanism to raise revenue. It will then discuss tax-base design decisions by national governments, such as territorial versus worldwide accounting, and the cross-border tax rules and transfer pricing rules—rules to govern related-entity transactions—that operationalize these systems.

The Corporate Income Tax Is a 20th-Century Relic

The complexities and costs imposed by the corporate income tax are not a necessary evil. Each of the issues described in the remainder of this policy analysis would be moot if the United States were to repeal its corporate income tax to rely on less volatile and more economically efficient revenue sources such as consumption-based taxes.

Widely understood by economists to be an inefficient mechanism for funding governments, the corporate income tax is an overly complex second layer of tax on income that is also taxed at the individual level when the owners realize the profits as capital gains or dividends. This two-layer system double-taxes some corporate profits, creates avoidable economic distortions, and obscures the economic effect of the tax.

> "The corporate income tax is an overly complex second layer of tax on income that is also taxed at the individual level."

Surveys of the academic literature find that corporate income taxes are almost universally associated with significant negative effects on investment, wages, and economic growth.[8] In an increasingly global economy, more than half (and likely more than three-quarters) of the economic cost of the corporate tax is passed on to workers in the form of lower wages.[9] Ranking major sources of tax revenue, OECD economists concluded in a 2008 working paper that compared to taxes on physical property, labor income, and consumption, the corporate income tax is the "most harmful for growth."[10] The accumulated evidence against the corporate income tax has led many prominent economists to call for the United States to repeal the corporate income tax, following the lead of 16 other countries.[11]

When businesses were constrained mainly by local geography and high trade frictions, countries could levy economically costly taxes more easily without losing residents or businesses to other jurisdictions. As cross-border trade increased and firms began to leverage tax rules to their advantage, countries faced pressures to reduce the economic costs of their business taxes by lowering rates and exempting some foreign income (see "Tax Competition" section). The other response was a series of cross-border tax rules to define and protect the domestic tax base when tax rates remain uncompetitively high. The balancing act of high tax rates and anti-abuse rules (which seek to prevent business income from being artificially moved to low-tax jurisdictions) provides life support for a 20th-century tax in a 21st-century world.

Most of the international tax policy debate has centered on how countries choose to define the corporate tax base and the tax rate, but countries can also choose to have no corporate income tax at all. Repealing the corporate income tax would make the complex and costly rules governing the base unnecessary.

Territorial and Worldwide Taxation

Most countries' corporate tax regimes exist on a continuum between territorial systems that levy taxes based on the source of the income and worldwide systems that tax income based on corporate residence, regardless of where the income is earned. No tax system is a pure manifestation of one or the other; most tend to blend elements of different systems. This section will focus on the primary differences between territorial and worldwide tax systems.

Worldwide tax systems tax the income of resident entities irrespective of where the income is earned. This aligns closely with what is called capital export neutrality, whereby outbound investments made in foreign countries by domestic residents face at least the same tax burden as similar domestic investments. For example, a US-headquartered firm would pay the same amount of corporate tax on the income earned in the United States and income earned overseas.[12]

Worldwide systems can be better at ensuring multinational income is not inadvertently shielded from taxation, but they can also lead to high economic costs and administrative burdens due to the need to track and account for income generated abroad. Taxing income earned outside a country's borders—where the income is usually subject to foreign income taxes—requires mechanisms such as foreign tax credits (FTCs), domestic tax deferrals, and tax treaties to ensure foreign-source income is not double-taxed, which would subject it to a higher tax rate than domestic income. FTCs allow taxpayers to offset their domestic tax bill by the amount of tax paid to foreign jurisdictions on foreign-source income. Tax deferral enables domestic firms to delay paying taxes, sometimes indefinitely, on foreign income until the income is repatriated (distributed to the domestic parent).

As cross-border trade increased through the 20th century, governments and companies began to consider capital export neutrality as an impediment to domestic business investments abroad. Worldwide tax systems disadvantage domestic firms' foreign investment when domestic tax rates are higher than foreign tax rates. For example, a US-based firm that had to pay the 39 percent federal and state combined corporate tax rate in 2017 would effectively pay a tax rate 14 percentage points higher than its competitors with investments in a typical OECD country with average combined tax rates of about 25 percent in that same year.[13] While foreign-based businesses with investments outside their home countries' borders would pay their respective local tax rates, US firms ultimately would have to pay the higher US rate on their foreign income.

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Territorial systems implement capital import neutrality by trying to ensure two investments in the same location face the same tax rate, regardless of where the investor is located. This type of system facilitates foreign investment by domestic firms by equalizing foreign effective tax rates and reducing multiple taxation of the same income.

Capital import neutrality is reached by taxing only the income generated within a nation's geographical boundaries, excluding income generated abroad and the taxes paid on foreign income. This domestic tax exclusion is implemented through a participation exemption (designed to avoid double taxation) for all or a portion of foreign-earned capital gains and dividend income. Most OECD countries have full territorial systems that exempt 100 percent of both types of income. Some countries, such as Spain and France, offer partial exemptions, and others, such as the United States and Poland, exempt only dividend income.[14]

At the beginning of the 20th century, all but one OECD country had a worldwide tax system. By 2017, the United States was one of only six countries that taxed worldwide business income. Beginning in 2018, the United States switched to a territorial system.[15] Only Chile, South Korea, and Mexico still have worldwide tax systems as of 2023.[16]

A worldwide tax system with high tax rates can devastate domestic ownership of foreign industries. When Congress eliminated any ability to defer domestic taxation on foreign

shipping income in 1986, moving the US shipping industry to a strict worldwide tax system, the share of US-owned foreign-flagged ships declined by almost 50 percent between 1988 and 1999. Deferral for shipping income was reinstated in 2004.[17]

Despite generous deferral allowances on large portions of foreign income, by the early 2000s, US-based firms could not effectively compete abroad with foreign firms paying lower tax rates. Much like the shipping industry in the 1990s, US firms responded to the incentives of the worldwide tax system. They moved their headquarters overseas, often by buying a smaller competitor as part of a corporate "inversion." More than 60 firms moved their headquarters overseas in the decade before the 2017 US corporate tax cut.[18]

While territorial systems can be simpler because they disregard activity outside the territory, they can also open arbitrage opportunities. Thus, most territorial tax systems employ various anti-abuse rules to protect the domestic tax base. These rules, such as partial participation exemptions, create a territorial-worldwide hybrid system of varying degree. Other common cross-border tax rules include controlled foreign corporation (CFC) rules and limits on intraparty payments.

Controlled foreign corporation rules. CFC rules identify qualifying foreign subsidiaries that trigger certain thresholds, such as a low effective tax rate or location in a blacklisted country. If the CFC rules apply, certain types of easily manipulated income, such as royalties and interest, are taxed immediately as domestic income of the parent company—as if under a worldwide tax system.[19]

Intraparty payment limits. Many jurisdictions impose restrictions on deductible payments to related parties, aiming to prevent multinationals from unduly maximizing deductions in high-tax jurisdictions. The most common limits are placed on interest deductibility, such as the United States' limit on interest expense at 30 percent of earnings before interest and taxes (EBIT) or the more common limit based on a less restrictive denominator of earnings before interest, taxes, depreciation, and amortization (EBITDA).[20]

Other rules, such as diverted profit taxes and the US Base Erosion and Anti-Abuse Tax (BEAT) on certain intrafirm payments, serve similar functions. Withholding taxes are a blunter tool that requires a paying corporation to withhold a percentage of cross-border payments, including interest, dividends, and royalties, to be remitted to the home country's tax authorities. Among other cross-border coordinating functions, tax treaties often reduce or eliminate withholding taxes on payments between countries party to the agreement.

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By expanding the domestic tax base to some types of foreign-source income (often easily manipulated types of passive income), most cross-border tax rules undermine the benefits of a complete territorial regime by adding complexity and opportunities for double taxation. Many worldwide tax systems use similar tools to protect their tax base from indefinite deferral.

Destination-Based Tax Systems

In addition to the territorial versus worldwide continuum, another principle of international corporate taxation has grown in popularity, though primarily as an academic exercise.[21] So-called destination-based tax systems tax profits based on where the customers or end users are located instead of the location of the production or headquarters. In its pure form, a destination-based corporate income tax eliminates incentives to shift the location of business activity in response to tax rates. Still, real-world implementation faces several technical hurdles and economic risks.[22] The destination-based principle underlies elements of proposed and existing regimes, such as Amount A under the OECD Pillar One proposal (discussed in the section "Pillar One: Tax on Profitable US Multinationals"), digital services taxes, and some features of anti-abuse rules. Proposals for destination-based income taxes tend to be made as tools to raise revenue and expand tax bases to new sources of income not directly connected to the jurisdiction.[23]

Transfer Pricing Rules

The interconnected nature of the global economy requires multinational corporations to engage in cross-border transactions with international subsidiaries. Worldwide

and territorial tax systems must adopt rules to govern these intracompany trades to determine where income is earned and thus subject to tax. Beginning in the 1970s, there has been a growing consensus toward reliance on arm's-length transfer pricing as the standard method to determine where profits are taxed. Transfer pricing regulations stipulate that transactions of goods, services, and intangible assets between related parties should be conducted as if they were done at arm's length—so that the price is consistent with what would be agreed upon between unrelated parties under similar circumstances. This practice is extremely important within the existing international tax system due to its role in allocating profits among jurisdictions and its influence on the overall tax liability of multinational enterprises.

> "Corporate tax systems must adopt rules to govern intracompany trades to determine where income is earned and subject to tax."

While the principle of transfer pricing is straightforward, the implementation of the rules is highly complex. The OECD's guidelines specify five different methods of determining the transferred asset's price, depending on the characteristics of each separate transaction.[24] Each of these methods may be applied very differently depending on the circumstances surrounding the transaction.[25] The transfer price can be relatively straightforward when the transferred asset has a comparable transaction between unrelated entities, such as the sale of a physical product or commodity. However, the transfer of items such as proprietary intellectual property for which there is no comparable market product presents both technical and theoretical challenges.[26] In these cases, the rules are more ambiguous, which allows multinationals to manipulate where they report profits.

Although not formally part of the international tax system, the other way to assign income is to account for all corporate income and then divide it between taxing authorities by an arbitrary formula. American states allocate income using this method, known as formulary apportionment. For example, some states use a three-factor formula based on a business's fraction of its total property, payroll, and sales within the state.

Academics who study tax often favor apportionment as a simpler and harder-to-game alternative to transfer pricing. However, apportioning income without a somewhat uniform and centrally coordinated tax base and formula used by all tax jurisdictions creates opportunities for double taxation. Such a system can also disconnect taxes from the activities and investments that generate the income, distorting important political and economic incentives.[27] This is especially true if the formulary system lacks effective permanent establishment criteria, such as in the OECD's Amount A under Pillar One. Permanent establishment rules determine if the multinational's activity is locally taxable by setting physical presence or other requirements for substantial economic connection.

EVOLUTION OF INTERNATIONAL TAX RULES

This section will briefly describe the evolution of international tax rules and how that history influences the most recent policy developments. This will provide important context for the final section of this report, which presents options for reforming the US international tax system.

The OECD is at the center of this history. The organization once served an important role in constraining international tax systems to reduce double taxation and other trade barriers. In recent decades, and most recently through its Two-Pillar proposal, the OECD has pivoted from its founding mission, now advocating for policies that increase corporate taxes, compromise national tax sovereignty, favor centralized control of tax systems, and expose firms to new forms of double taxation. The misguided evolution of OECD policy has often been modeled on similar misguided expansions of international tax authority by American policymakers.

US Policy Expands Domestic Taxes beyond Borders

In the first half of the 20th century, American international tax policy was guided by relative restraint in taxing foreign income. The Revenue Act of 1918 was a significant milestone in international tax policy, introducing the concept of the foreign tax credit (FTC), which allowed American taxpayers a credit against their US tax liability to offset taxes paid to foreign governments. The US FTC was revolutionary at the

time, as it required the US Treasury to assume the full cost of reducing the double taxation of foreign income. Legal scholars Michael Graetz and Michael O'Hear note that "such generosity was virtually unprecedented" at the time.[28] The FTC and deferred taxation of resident firms' foreign income—a feature of the US tax code since its inception—allowed the United States' worldwide tax rules to persist for an entire century by partially protecting the worldwide system from international pressures.

> "The OECD has abandoned its founding mission. It now advocates for policies that increase corporate taxes, compromise national tax sovereignty, favor centralized control of tax systems, and expose firms to new forms of double taxation."

Under the Kennedy administration, assistant secretary for tax policy Stanley Surrey pursued more extensive export neutrality by expanding the immediate taxation of foreign-source income. Facing several political incentives, including concerns over the balance of payments, profit shifting, and budget deficits, US policymakers implemented a series of reforms that culminated in the enactment of CFC rules under Subpart F of the Internal Revenue Code in 1962. The new Subpart F income—which included passive income sources of overseas corporations controlled by US shareholders, such as dividends, interest, royalties, and certain types of rents—was treated as if it were immediately distributed to US shareholders and thus subject to immediate taxation. Before the 1960s, it was generally understood that a country could not immediately tax the profits of independent businesses operating overseas, even if those businesses were owned or controlled domestically.[29]

As the first-of-its-kind CFC rule, Subpart F began a gradual shift in global tax regimes. Beginning in the 1970s, other countries—led by Germany, Canada, and then Japan—began implementing their own, often more expansive CFC rules, eventually directly taxing active and passive foreign-source income.

In the 1970s and 1980s, Congress and successive administrations enacted reforms that refined the definitions of Subpart F income and made other modifications to US international tax rules, including new restrictions on FTCs. These changes aimed to limit firms' ability to arbitrage tax rules using CFCs in low-tax jurisdictions and FTCs in higher-tax countries.[30] One summary concluded that because of the 1980s changes, "the competitiveness of foreign operations of US companies has been significantly impaired."[31]

However, the 1990s saw a recalibration of this approach. Starting in the mid-1990s, legislative and regulatory adjustments provided relief from some of the broad Subpart F inclusions in the previous decade. One pivotal moment came in 1996 when the Treasury Department made elective entity classification easier under "check-the-box" regulations, allowing certain business entities, including foreign ones, to be disregarded for US tax purposes.[32] This provided planning opportunities that sometimes allowed US multinationals to sidestep Subpart F inclusions and defer US tax on certain foreign earnings.

During this time, there was also a significant evolution of transfer pricing rules. As the system responded to the increasing prevalence of difficult-to-value intangibles and proprietary technologies, increasingly abstract and formulaic valuation methods, often led by the United States, became popular.[33] Beginning with the Foreign Account Tax Compliance Act (FATCA) of 2010, the United States also led the international proliferation of US and foreign taxpayer information exchange agreements under the auspices of reducing tax evasion and avoidance.[34]

The OECD Shifts Focus to Increase Taxes on Multinational Firms

As global trade increased during the 1950s and countries began expanding their tax bases in the 1970s, multiple countries claimed taxing rights to the same corporate profits. That led to double taxation and created new obstacles to international trade and globalization. The OECD—the successor organization to the similar post–World War II Western Europe Organisation for European Economic Co-operation—was established in 1961 to preserve individual liberty and increase general well-being through expanded trade and international investment.[35]

In 1963, the OECD published its *Draft Model Convention on Income and Capital*, an ambitious model treaty to resolve the problem of double taxation.[36] Through its model convention, the OECD's primary tax mission for its first three decades was coordinating tax systems to address double taxation.

A 1981 Carter administration Treasury report, *Tax Havens and Their Use by United States Taxpayers* (also known as the Gordon Report), launched what has metastasized at the OECD as successive projects to increase taxes on international business.[37] In the 1980s the OECD released two reports on tax havens, and in 1998 it released a report on international tax competition that marked a distinct shift from its previous work.[38] The report, titled *Harmful Tax Competition*, concludes that taxes should not be used to attract business investments because tax competition could undermine domestic income redistribution.[39]

> "The OECD concluded that taxes should not be used to attract business investments because tax competition could undermine domestic income redistribution."

The OECD's tax work shifted from primarily coordinating tax systems to eliminate double taxation to proposing ever more complicated new tax systems and reporting requirements to ensure every dollar is taxed at the OECD's preferred minimum rate. In a 2012 tax law journal article, Andrew Morriss and Lotta Moberg characterize the OECD's campaign against tax competition that began in the 1980s as the organization's effort to form an international tax cartel run by a special interest group of tax collectors.[40]

The OECD's most recent initiatives add a new dimension: centralized reallocation of taxing rights from the countries where productive activity occurs to countries where goods and services are sold or revenue is needed most, as determined by the OECD. In addition to fundamentally changing the international tax system, the OECD's policy initiatives increasingly advocate for "whole-of-government strategies" to meet ever-changing economic, environmental, and social goals often at odds with its founding mission.[41]

Tax Cuts and Jobs Act Overhauls US Tax System

The business and international provisions in the Tax Cuts and Jobs Act (TCJA) of 2017 were motivated chiefly by the United States' increasing outlier status as the country with the highest corporate tax rate in the developed world and one of a few major countries with a worldwide tax system. In the decade before the reform, more than 60 US multinationals moved their headquarters overseas through a tax-motivated corporate inversion, and the Joint Committee on Taxation estimated US firms held about $2.6 trillion in untaxed foreign earnings overseas as they tried to avoid the US tax system.[42] In response to these international pressures, the 2017 law cut the headline corporate tax rate from 35 percent to 21 percent and moved the United States toward a territorial system. The law also made significant reforms to the individual tax system.[43]

Responding to the US experience in the decade before the 2017 tax cut and building on proposals from 2014 and 2016, reformers were overly preoccupied with designing new rules to discourage profit shifting. Thus, Congress paired the lower headline corporate tax rate and partial participation exemption (territorial treatment) with a three-part anti-base-erosion regime. The US participation exemption provides a deduction for 100 percent of dividends received; the exemption does not apply to foreign capital gains income. Many of the rules include automatic tax increases on foreign income in 2026.

The first anti-abuse rule is a new category of CFC income called Global Intangible Low-Taxed Income (GILTI). GILTI represents an internationally novel expansion of CFC income to all types of foreign-earned income, not just passive income, and formulaically taxes a portion of these profits rather than identifying specific types of income predisposed to abuse. GILTI effectively applies a minimum tax between 10.5 percent and 13.125 percent (increasing in 2026 to 13.125 percent and 16.406 percent) on income that exceeds an arbitrary 10 percent return.[44]

To compute GILTI income, companies deduct 10 percent of tangible asset income, such as buildings, plants, and equipment—called Qualified Business Asset Investment—from qualifying foreign income (Net Tested Income). An 80 percent limit on the associated FTCs can increase the 10.5 percent minimum tax rate to 13.125 percent (16.406 percent in 2026) for many firms. Other pre-2017 provisions, such as expense allocation rules, can further increase effective tax

rates on GILTI income.[45] These rules are intended to raise taxes on foreign "supernormal returns" over 10 percent, which is arbitrarily assumed to result from intangible assets shifted overseas without corresponding physical investments.

The GILTI tax penalty was paired with a new tax incentive for similar types of intangible income through a deduction for Foreign-Derived Intangible Income (FDII). This allows a 37.5 percent deduction for foreign export income connected to intangible assets held in the United States.[46] Under a 21 percent tax rate, the deduction creates a lower effective tax rate of 13.125 percent on eligible income. In 2026 the FDII deduction decreases to 21.875 percent, resulting in a 16.406 percent effective tax rate.[47] FDII creates an intellectual property export subsidy—similar in objective to patent boxes, which offer special tax treatment for income derived from locally held patents—to incentivize firms to report income from intellectual property in the United States. The FDII carrot and the GILTI stick create a preferential worldwide US tax rate on intangible income or, more precisely, on income that exceeds 10 percent of tangible investments.[48]

> "In 2017, tax reformers were overly preoccupied with designing new rules to discourage profit shifting."

The third anti-abuse rule is the Base Erosion and Anti-Abuse Tax (BEAT), which applies a minimum tax of 10 percent (12.5 percent starting in 2026) to income of large affiliated foreign entities with gross receipts of $500 million or more and significant intrafirm cross-border transactions. The tax applies if qualifying base-erosion payments—interest, rents, royalties, services, depreciation, and amortization—exceed 3 percent of total corporate deductions.[49] The tax is intended to discourage earnings stripping, in which firms inflate payments and other deductions (deductible against the US tax base) in low-tax jurisdictions.

The Inflation Reduction Act's Book Minimum Tax

In 2022, Congress passed the Inflation Reduction Act (IRA), which included a new 15 percent Corporate Alternative Minimum Tax (CAMT) based on modified financial statement income. Unlike the TCJA guardrails, which address cross-border profit shifting, the CAMT is designed to close the gap between effective tax rates as measured by financial statement income and taxable income, which is largely due to timing differences.[50] Despite the motive, lawmakers ultimately exempted many mechanisms that companies use to lower their effective tax rates, such as credits for R&D, energy tax credits, net operating losses, and accelerated investment deductions.

CAMT works at cross purposes with the TCJA international regime and the OECD Pillar Two minimum tax proposals (described in the next section). Initially intended to bring the United States into compliance with the OECD, the IRA international provisions evolved during negotiations in Congress, and the OECD-compliant minimum tax was ultimately dropped from the final legislation.

THE OECD TWO-PILLAR APPROACH TO REDISTRIBUTE THE GLOBAL TAX BASE

In October 2020, the OECD outlined a "Two-Pillar" approach to remaking the international tax system. The executive branches of nearly 140 countries have signed on, including the Biden administration.[51] The proposal is intended to change the taxation of multinational businesses by raising effective tax rates and reallocating taxing rights away from some countries to others. Pillar One aims to change where some companies pay taxes, selectively moving toward a system based on customer location instead of business activities. Pillar Two includes a series of new rules that enforce a global minimum tax of 15 percent. The broad contours of the proposal—specifically the minimum tax and the profit margin threshold—are based on the 2017 US anti-abuse rules.

Pillar One: Tax on Profitable US Multinationals

In October 2023 the OECD released draft text for the Multilateral Convention to Implement Amount A of Pillar One.[52] The proposed rules threaten to further destabilize the international tax system while not replacing the most discriminatory digital services taxes.[53]

Pillar One would reallocate an estimated $205 billion of large multinational corporate profits to countries where

customers are located and away from where the firms have a physical and productive presence.[54] This would be done with a complicated formula based on a company's sales, marketing, and distribution in each jurisdiction. Amount A of Pillar One applies to companies with more than €20 billion ($22 billion) in revenues, falling to €10 billion ($11 billion) after seven years, and a global profit margin above 10 percent.[55]

Amount A is intended to replace a patchwork of digital services taxes, which some countries currently charge large technology firms based on revenue and users in their country. The domestic populist European politics that supports taxing the most profitable American companies through digital services taxes is also a driving force behind Pillar One. At its core, Pillar One is a specially tailored destination-based tax designed to hit industries where the United States is the most common source and Europe the most common destination. The result is that Pillar One would apply mainly to large US-based businesses. By one estimate, US companies make up 46 percent of firms covered by Pillar One, representing 58 percent of profits redistributed under Amount A.[56]

If governments wanted to raise revenue based on consumption—and not just from US-based firms—they could choose to use purpose-built consumption taxes that raise significant revenue in every major country. Instead, Pillar One effectively turns part of the corporate income tax into a type of sales-apportioned income tax with largely unknown economic effects and is further distorted by a gross receipts threshold.

Pillar One also includes Amount B, which could provide a more formulaic transfer pricing method for marketing and distribution. Work on Amount B continues. Ultimately, to fully implement Amount A, and possibly Amount B, the major signatories would need to meet the high bar of mutual agreement and passage of a multilateral treaty, in addition to significant changes to domestic tax laws.

Pillar Two: Minimum Tax

Pillar Two comprises five new rules that work together to enforce a global minimum tax rate of 15 percent on businesses with more than €750 million ($825 million) in revenues. Pillar Two is estimated to raise between $155 billion and $192 billion in global tax revenue each year.[57] Extrapolations from German data suggest that the new tax system could impose about $60 billion in annual economic and administrative costs.[58] Because the tax revenue is simply a transfer from the private sector to governments around the world—and thus generates gains only to the extent that the governments spend the money more efficiently than the private sector—the new minimum tax would come at a substantial net cost to the global economy.

> "Pillar One is a specially tailored tax designed to hit industries where the United States is the most common source and Europe the most common destination."

The Pillar Two rules primarily target American firms. By one estimate, US businesses earn nearly 40 percent of all in-scope multinational income, about the same amount as the next 10 countries' shares combined.[59] The Joint Committee on Taxation estimates that Pillar Two could reduce US domestic tax revenues over 10 years by between $122 billion (if other countries implement the OECD tax and the United States does not) and $57 billion (if Congress agrees to implement the OECD international tax rules).[60] The revenue loss does not come with the economic benefits of lower tax rates or other reforms.

The first new rule is the Qualified Domestic Minimum Top-Up Tax (QDMTT), a minimum tax allowing countries the first right to tax their domestic entities at a 15 percent rate on a novel tax base. The QDMTT tax base allows the most flexibility in how countries customize its design and implementation, which opens up significant opportunities to write rules that maximize local taxation of US business income.[61] Second, the Income Inclusion Rule (IIR) requires parent companies to include in their taxable income the profits of their foreign subsidiaries that have not been taxed at the minimum 15 percent rate.

Third, the Undertaxed Profits Rule (UTPR) allows countries to increase taxes on a business's domestic subsidiary if a related entity in another jurisdiction pays a tax rate below 15 percent. The UTPR creates a backstop for the QDMTT and

IIR by allowing foreign countries to tax firm profits in other countries if tax rates are lower than the OECD minimum rate.[62] This mechanism to disallow any country taxing local economic activity below a 15 percent rate represents an unprecedented incursion into domestic sovereign taxing authority.[63] Columbia University legal scholar David Schizer likens the UTPR to California being able to tax a resident of Virginia on income earned in Virginia simply because his daughter lives in California.[64]

The UTPR's tax base disfavors US-style nonrefundable tax credits compared to refundable credits and direct state subsidies. Nonrefundable credits reduce taxes paid, directly lowering effective tax rates, which can trigger the OECD minimum tax rules. Direct subsidies also reduce effective tax rates but by much less, because they show up as income. For example, if a firm makes $100 in profit, pays $16 in taxes, and receives a $5 nonrefundable credit, the firm's effective tax rate is 11 percent, but the effective tax rate remains above 15 percent if the subsidy is a direct payment or fully refundable credit. In this scenario, the firms are economically identical. However, using the US-style credit would push the effective tax rate below the OECD minimum, triggering additional taxes, while the direct subsidy would not. Through this design feature, the UTPR implicitly promotes jurisdictional competition using state subsidies and other industrial policy tools.

The UTPR tax base includes allowances for investment deductions and a substance-based income exclusion, which removes a portion of tangible assets and payroll from the tax base.[65] The exclusion starts at 10 percent for payroll and 8 percent for tangible assets. The carveout percentages each decline to 5 percent over a decade. The carveout allows the headline minimum tax rate to fall below 15 percent if profits are aligned with physical activity as measured by assets and payroll. Some practitioners worry that this carveout undermines the effectiveness of the minimum tax at enforcing a true 15 percent floor on global tax rates.[66] If countries continue to compete on policies such as full expensing to attract investment and jobs, it might mitigate some of the negative effects of Pillar Two. However, if competition for investments were to turn on direct subsidies instead—as we have already seen in Vietnam and across the European Union—the substance-based carveout could accelerate the worst forms of fiscal competition.[67]

In July 2023 the OECD announced a safe harbor transition rule that delays the application of UTPR into 2026 for entities in jurisdictions with statutory corporate income tax rates of at least 20 percent.[68] This delay is widely understood as intended to target the United States, aligning the OECD calendar with the US domestic legislative tax calendar when significant components of the TCJA expire at the end of 2025.

The final two components of Pillar Two include the denial of tax treaty benefits to companies in noncompliant jurisdictions (the Subject to Tax Rule, or STTR) and anti-base-erosion reporting rules on corporate structure, country-by-country income, and taxes paid—all of which amounts to thousands of novel data points for tax reporting.[69] The agreement mandates that tax authorities automatically exchange this private financial data, including corporations in the technology and defense sectors, with various world governments, many of which are corrupt and hostile to Western countries.

"Pillar Two implicitly promotes jurisdictional competition using state subsidies and other industrial policy tools."

Overall, the rules proposed by the OECD are a dramatic departure from both the agreed-upon current international tax system and the principle that countries have sole sovereignty over domestic activities. The OECD proposals are largely a response to perceived and real pressures of tax competition and multinational tax planning, which, over the past four decades, have helped encourage domestic tax reforms that reduced the economic costs of corporate taxes and facilitated the growth of international investment. By attempting to harmonize national tax systems to reduce tax rate competition, the OECD effort will likely reduce international investment and growth, undermine local sovereignty, encourage industrial planning through state subsidies, and destabilize the international tax system.

TAX COMPETITION

In a world where capital investments, business headquarters, and individuals are increasingly mobile, government policies are often strategically adjusted to keep

or attract these assets. By the same token, multinational firms have strong incentives to minimize taxable income and any associated physical investments in high-tax countries and maximize profits in low-tax countries. The OECD's proposed rules are primarily targeted at stopping this behavior. This section will first give a brief overview of how multinational firms strategically interact with international tax rules, and then discuss the incentives faced by states that lead to tax competition.

Multinational Businesses Invest Strategically to Lower Taxes

Multinationals make strategic decisions on every margin of their operation, and these decisions are often influenced by tax rates and cross-border tax rules. If a firm faced a choice of relocating to one of two countries that were identical in every respect other than tax policy, it would likely choose the country with the lower tax rate. If tax rates were the same, the firm would choose to headquarter in the country with a territorial regime and an extensive tax treaty network.[70] It would place manufacturing and other physical assets in jurisdictions with full deductions for investments, such as full expensing or other similar incentives, and intellectual property and R&D in countries with favorable tax treatment for patents, other intellectual property, and research spending.

In addition to influencing real economic activity, tax regimes also help determine the location of paper profits—the portion of multinational income that can be disconnected from physical activity. Primarily influenced by differences between tax rates, the two main ways profits are artificially shifted between countries are by taking advantage of the complexity and lack of precision in transfer pricing rules and through the allocation of intrafirm debt. One meta-analysis estimated that about two-thirds of worldwide profit shifting is done through transfer pricing and one-third through financial techniques, such as allocating debt to high-tax countries where interest payments are deductible from taxable income.[71]

Some multinationals can arbitrage transfer pricing to manipulate income allocation between jurisdictions as a way to reduce global tax liability. Suppose a multinational corporation develops a new drug in the United States at a cost of $100. It sells the patent for a new—but not yet market-proven—drug to the Cayman Islands at the $100 cost of development, leaving no profit in the United States.[72] The Cayman Islands affiliate then licenses the patent rights to another affiliate in Germany for $300, which is the full expected revenue from selling the drug. In this simplified example, the $200 profit from the drug developed in the United States and sold in Germany is registered in the Cayman Islands. Thus, the multinational's profits are taxable in no-tax Cayman Islands and incur no tax in the United States or Germany.

> "The agreement mandates the automatic exchange of private financial data with various world governments, many of which are corrupt and hostile to Western countries."

The above example is extreme and highly stylized, but transfer pricing arbitrage usually happens because the different transfer pricing methods typically produce ranges of prices instead of point estimates, allowing firms to choose the most advantageous price for each transaction. By choosing the most favorable method and pricing result, firms can effectively reduce a portion of taxable profits in high-tax countries and increase profits in low-tax nations.[73]

The complex arrangements that allow for profit shifting often involve multiple subsidiaries and go by names such as the "Double Irish" (with or without a "Dutch sandwich"), "Single Malt," or "Green Jersey."[74] These maneuvers are usually shut down by one or more of the party governments once discovered. Still, the complexity of the international tax system often means that new legal loopholes are generally available to firms with financial resources, sophisticated tax lawyers, and a willingness to take the reputational and tax compliance risk.

The second primary method of shifting profits involves borrowing in high-tax jurisdictions, where interest payments are often deductible, and lending from low-tax jurisdictions, where interest income is more lightly taxed. For example, a firm can borrow $1,000 at a 10 percent interest rate from a

subsidiary in a no-tax country. The $100 deductible interest payment reduces taxable income by $100 in the high-tax country. The $100 of interest income is earned by the firm's subsidiary in the no-tax country and is therefore not taxed. Intraparty payment limits in various countries help guard against this practice of earnings stripping.

Tax Competition Lowers Tax Rates but Not Tax Revenue

Understanding that businesses adjust to the incentives of tax policy, policymakers can also adjust their tax policies to attract foreign investment, prevent capital flight, maintain headquarters, and attract inbound profit shifting. Thus, countries compete for multinational activity by cutting corporate tax rates, moving toward territorial systems, and reforming other cross-border tax rules.

Beginning in the late 1970s, floating exchange rates, global trade growth, and more sophisticated financial products increased tax competition between governments as firms could more efficiently plan their global operations.[75] Tax competition is formally modeled in several academic papers, generally as the noncooperative setting of tax rules to influence the distribution of global investments.[76] These models build on the classic insight from economist Charles Tiebout that competition between jurisdictions creates a secondary political constraint via physical exit.[77] The results of the competitive tax games vary depending on the assumptions but often predict that tax competition will result in a race to lower tax rates. Empirically, we see that the ability for businesses to move between countries constrains domestic politicians' ability to impose taxes at confiscatory rates—but does not push them close to zero on average—and keeps effective tax rates lowest on those investments that are most sensitive to high tax rates, increasing one margin of economic efficiency.[78]

Tax competition exists thanks to the diversity of global tax rules and jurisdictional autonomy to design systems that allow strategic investment decisions. Countries compete on various criteria, including resources, workforce characteristics, infrastructure, regulatory systems, rule of law, and state subsidies. Whether a business moves between tax jurisdictions for a better-educated labor force or a more friendly tax code, the effect on the tax base is the same: it shrinks in one place and expands in another. Tax rates and the tax base are just two of many policy-related margins on which countries compete for global investment. There is no theoretical reason to treat competition on tax rates differently from improvements in the rule of law and education.

The pressures of tax competition have been widely credited with facilitating reforms to corporate taxation, particularly on the margin of tax rates.[79] Figure 1 shows that the global distribution of corporate tax rates shifted significantly between 1980 and 2022. The global average rate declined from 39 percent in 1980 to 22 percent in 2022. The number of worldwide tax systems similarly decreased steadily, from 30 OECD countries in the 1960s to just 3 in 2022.[80]

"There is no theoretical reason to treat competition on tax rates differently from improvements in the rule of law and education."

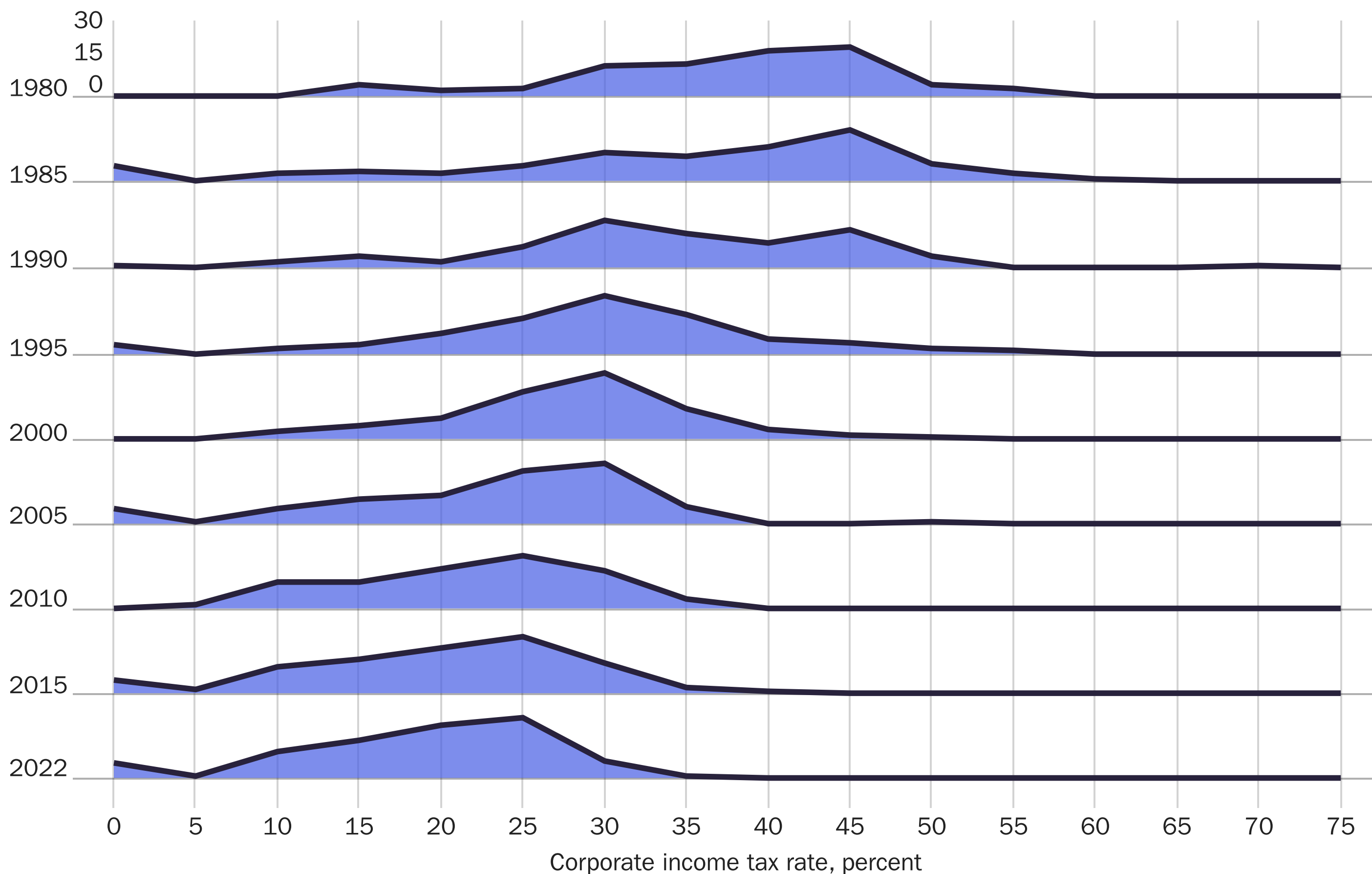
Skeptics of tax competition and the associated tax reforms often deride the changes as "harmful tax competition" that creates an environment where countries' tax codes are in a race to the bottom.[81] International organizations such as the OECD are concerned that by keeping corporate tax rates from remaining high, tax competition "may hamper the application of progressive tax rates and the achievement of redistributive goals."[82] These pressures created by strategic investment decisions of multinationals and legal tax minimization are no doubt real. As shown in Figure 1, average global tax rates have fallen considerably. However, the most dire predictions of the race to the bottom have not materialized. Average statutory corporate income tax rates have stabilized above 20 percent and have not significantly eroded corporate tax revenues.

Figure 2 shows that corporate tax revenue as a share of the economy increased from 2.2 percent in 1981 to 3.5 percent in 2021 across 19 OECD countries. Corporate tax revenue as a share of all revenue has also increased since 1981, rising from 8.6 percent of total revenue to 9.4 in 2021. These trends are even more impressive given that the average statutory corporate income tax rate across the same OECD countries was cut in half during the same time, falling from about

Figure 1

Corporate tax rates fall over four decades

Percent of countries with corporate income taxes at different rates, 1980–2022



Sources: Cristina Enache, "Corporate Tax Rates around the World, 2022," Tax Foundation, December 13, 2022; and author's calculations.
Notes: The 5 percent bucket includes rates 0–5 percent, 10 percent includes 5–10 percent, etc. Data include economic zones.

48 percent in the early 1980s to 24 percent in 2021. In the United States, corporate revenue, after being high in the 1970s, remained relatively stable between the 1980s and the 2020s, even as the corporate sector shrank as firms chose to organize as pass-through entities instead of C corporations.[83] International Monetary Fund data similarly show that developing countries have also not experienced a drop in corporate tax revenue.[84]

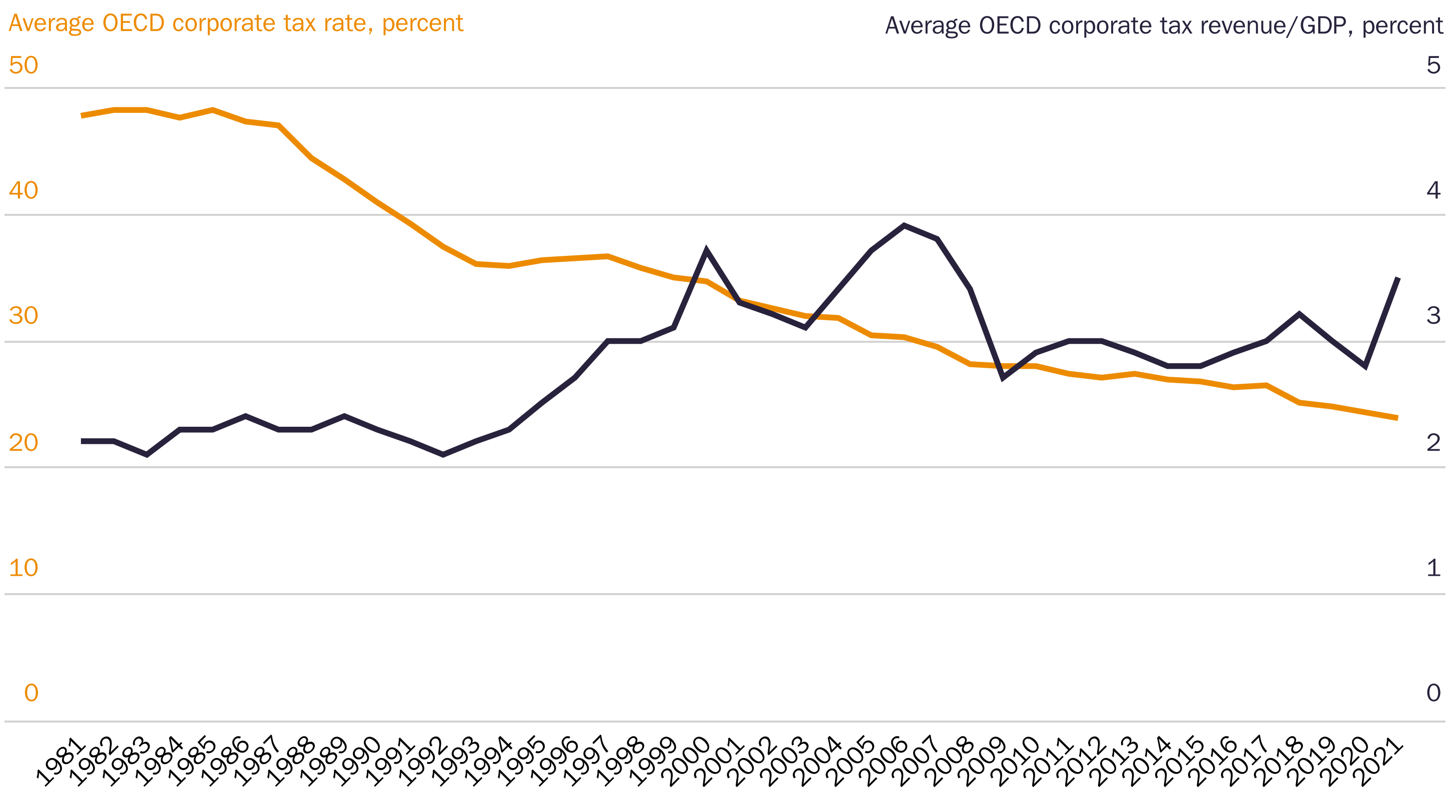
Because there is no counterfactual, skeptics might argue that absent tax competition and profit shifting, corporate tax receipts would have been even higher than they are today. However, if that were the case, we would expect a much higher share of profits in tax havens, lower effective tax rates for multinationals, and near-universal use of low-tax foreign affiliates. As will be discussed in the following sections, the data show the opposite. Some of the increased revenue may also be from changes in tax bases over time, such as interest deduction limits and controlled foreign corporation (CFC) rules. Regardless of the reason, the revenue trends in Figure 2 dispute the tax competition models and OECD statements that assume an unmitigated race to the bottom resulting in lost revenue and eroded state capacity.

EVALUATING BASE EROSION AND PROFIT SHIFTING

A common claim is that profit shifting is large and has increased significantly in recent decades, undermining the ability to raise sufficient revenue through the corporate income tax.[85] Knowing the true magnitude and distribution of multinational profits worldwide is critical to assessing the validity of these claims and the proposed policy responses.

Figure 2

Corporate revenue increases as tax rates decline



Sources: "Revenue Statistics—OECD Countries: Comparative Tables," OECD.Stat; "Table II.1. Statutory Corporate Income Tax Rate," OECD.Stat; Cristina Enache, "Corporate Tax Rates around the World, 2022," Tax Foundation, December 13, 2022; and author's calculations.
Notes: OECD = Organisation for Economic Co-operation and Development; average corporate tax rate combines national and subnational taxes; data for 19 OECD countries with consistent historical data.

Unfortunately, given the complex structures of modern multinational firms, the data on the location of corporate income around the world are notoriously imperfect and difficult to interpret. This section first assesses data from the US Bureau of Economic Analysis (BEA) on the location and relative magnitude of multinational foreign profits. It then reviews the complementary econometric literature on measuring profit shifting and its impact on effective tax rates. The section concludes by discussing profit shifting's effect on corporate tax revenue and, conversely, the corporate tax rate's effect on profit shifting.

Data on Multinational Business Income Overstates Tax Haven Profits

The BEA reports several measures of foreign corporate profits, each with advantages and disadvantages. The data show an uptick in the proportion of foreign profits declared in tax havens by US-based multinational corporations, but unadjusted metrics exaggerate the extent of the trend. The most straightforward measure of foreign income shows a precipitous rise in the share of income reported in tax havens beginning in the 1990s. However, other measures that more accurately attribute income to its source indicate a much lower level of income in tax havens and significantly temper the upward trend over time.

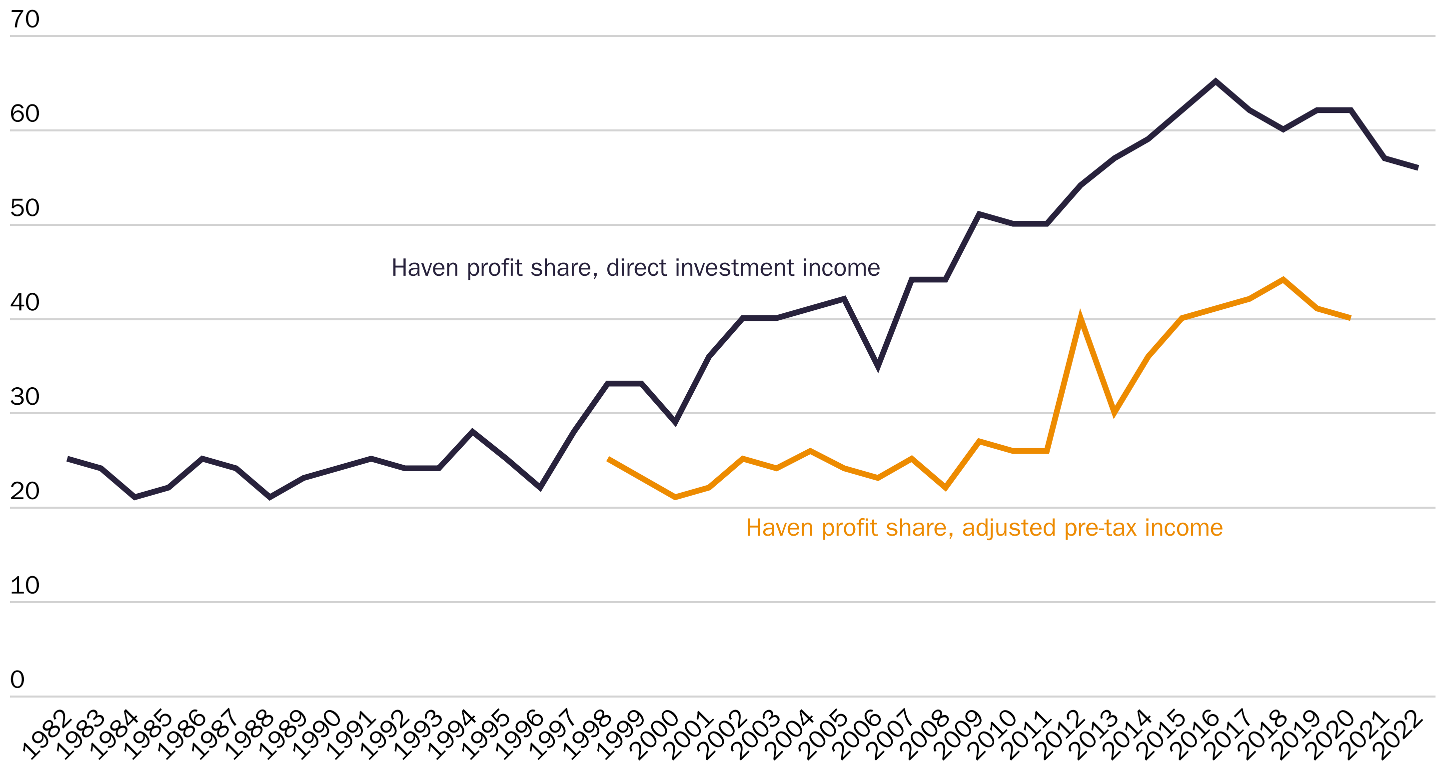
The top line in Figure 3 shows the share of US multinational foreign direct investment income (DII)—earnings accrued from investments abroad, such as through dividends or interest—reported in seven low-tax jurisdictions as a share of all foreign income.[86] The seven jurisdictions—Bermuda, the Cayman Islands, Ireland, Luxembourg, the Netherlands, Singapore, and Switzerland—are generally considered tax havens and follow the list developed by former Treasury deputy assistant secretary for tax analysis Kimberly Clausing.[87]

The DII data show the key trend motivating policy concerns over increasing profit shifting. By this measure, the

Figure 3

Tax haven share of US foreign profits, smaller when measured properly

Share of US foreign profits in seven major tax havens, percent



Sources: "US Direct Investment Abroad: Balance of Payments and Direct Investment Position Data," Bureau of Economic Analysis, last modified July 20, 2023; "US Direct Investment Abroad (USDIA)," Bureau of Economic Analysis, last modified November 17, 2023; and author's calculations.
Note: The seven tax havens are Bermuda, the Cayman Islands, Ireland, Luxembourg, the Netherlands, Singapore, and Switzerland.

tax haven share of foreign income began to rise from about 25 percent of all foreign profits in the 1980s to 65 percent in 2016. The data show a clear shift in trend in 2017, after which the tax haven share of US multinational foreign profits declined. However, DII systematically overstates income reported in tax havens relative to higher-tax jurisdictions. The second line in Figure 3 presents a more accurate measure of the havens' share.

Because multinationals tend to own affiliates in high-tax countries through holding companies in low-tax countries, DII does not correctly source income to its appropriate affiliate. For example, suppose a US multinational parent owns a German affiliate through an intermediate holding company in the Netherlands. In that case, BEA reports the German income on the Netherlands' account because the Netherlands is the terminal subsidiary in the cascading ownership structure.[88] DII is also reported after tax, which mechanically biases tax haven profits (which face low or no taxes) upward compared to those in higher-tax, nonhaven countries.

The BEA reports a second series called Activities of US Multinational Enterprises that includes data on net income of majority-owned foreign affiliates.[89] However, this data series also systematically overstates foreign income in tax havens by double-counting the profits of affiliates owned through an intermediary. For example, the income of an American-owned German affiliate, controlled through a Netherlands holding company, is reported first in Germany and then in the Netherlands as "income from equity investments," thus counting the German income twice. In more complex ownership chains, income could be counted much more than twice.

Using the series on Activities of US Multinational Enterprises, Jennifer Blouin of the University of Pennsylvania and Leslie Robinson of Dartmouth College suggest removing equity income and adding back foreign tax expense to estimate adjusted pre-tax income (adjusted PTI), shown as the lower line in Figure 3.[90] Adjusted PTI is a more faithful accounting of where profits are earned, but there remains some disagreement as to whether removing all equity income may

overcorrect the data and understate some profit shifting.[91]

The adjusted PTI series shows that the haven profit share of foreign profits is significantly lower than reported by DII. Through the 2000s, the haven share of adjusted foreign profits averaged 25 percent, reaching 44 percent in 2018 and falling thereafter. Over the past decade, the havens' share of adjusted PTI has been about 22 percentage points lower than as measured by DII. BEA data show that US multinational firms have increased the share of foreign profits reported in tax havens, but uncorrected measures overstate both the level and magnitude of the shift over time.

Profit Shifting Is Economically Small and Shrinking

The trend in the tax havens' share of foreign profits tells only part of the story. The overall magnitude of income reported in tax havens is relatively small when compared to total US corporate income instead of only foreign income (Figure 3).

The top line in Figure 4 shows tax haven DII as a share of total after-tax foreign and domestic US corporate profits. By this measure, haven profits averaged about 6 percent before 2007 and 14 percent after 2008. In 2022 tax haven profits were 11.2 percent.[92] The financial crisis and subsequent policy uncertainty likely accelerated the use of more aggressive tax planning, increasing haven profits in the late 2000s. Due to DII's overreporting of haven profits, the top line of Figure 4 shows an upper bound of tax haven income.

Adjusted PTI does not have a precisely comparable worldwide measure. Still, Figure 4 shows the tax havens' adjusted PTI share of total pre-tax corporate profits, using the pre-tax version of the same denominator as the top line.[93] By this measure, haven profits were 4 percent in 1998, rising to 12 percent in 2018 and falling to 8 percent in 2020. By both measures, the share of total US corporate income reported in tax havens grew modestly over time and most recently fell to its lowest level in a decade.[94]

Using tax data on country-by-country corporate profits shows similar estimates in other countries, such as Germany, where German multinationals report only about 9 percent of their worldwide profits in tax havens.[95] However, country-by-country tax data is relatively new and, like many other data sources, subject to numerous unresolved reporting issues and data inconsistencies.[96]

Empirical Literature Confirms Profit Shifting Is Economically Small

Multinational profits reported in tax havens are distinct from profit shifting, which is a type of income reported in low-tax jurisdictions. Some portion of tax haven income is associated with real activity—employment, property, plants, and equipment—while the remainder is artificially shifted income, independent of real activities. In a 2022 paper, University of Munich researchers estimated that approximately 60 percent of reported tax haven profits were not artificially tax-induced but rather the result of real investment activity.[97]

> "The share of total US corporate income reported in tax havens grew modestly over time and most recently fell to its lowest level in a decade."

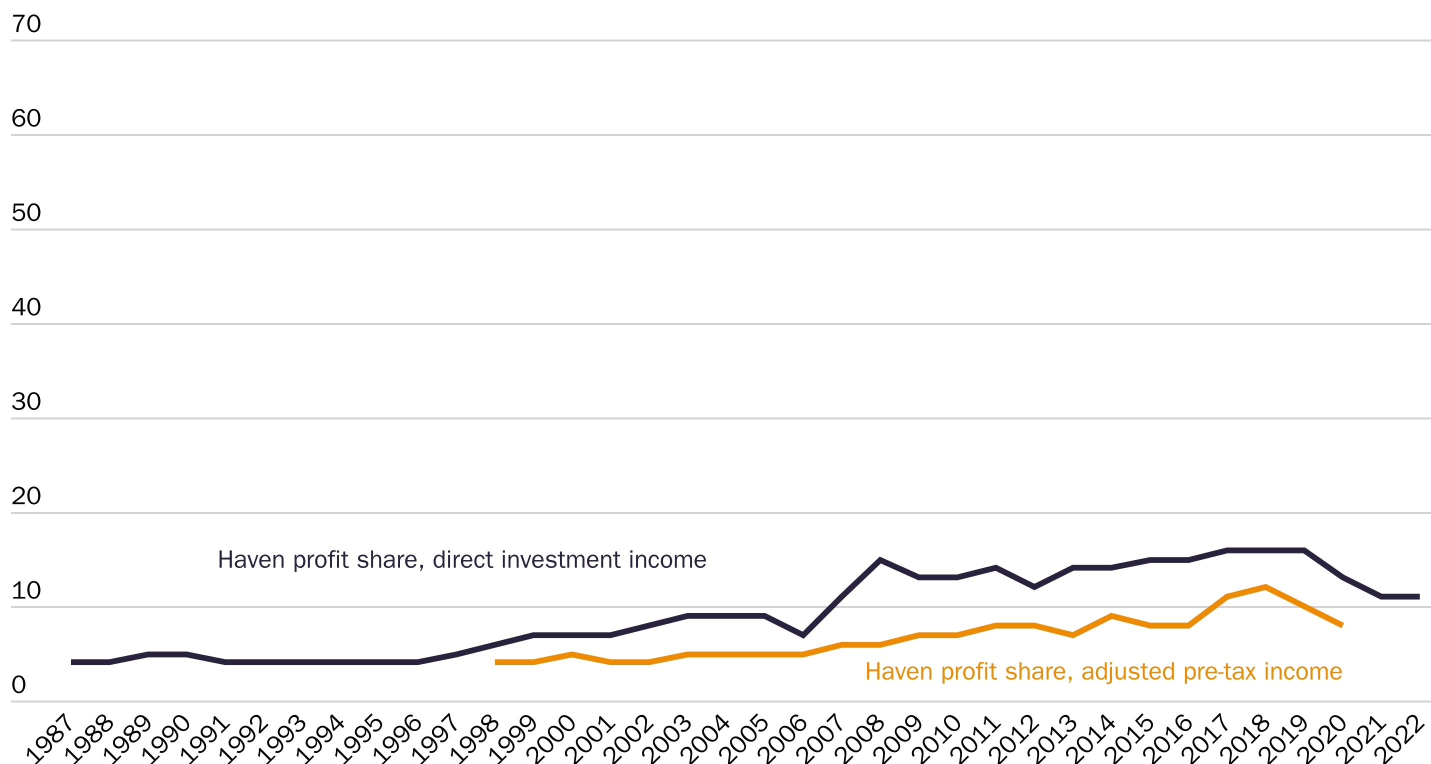
Data on multinational activity consistently show that firms place a higher share of real activity in low-tax jurisdictions than other features of their economies would suggest is normal. For example, a literature review from 2021 noted that, in 2016, havens accounted for 0.9 percent of the world population outside the United States and "13.5 percent of foreign property, plants, and equipment of US multinational firms, 9.1 percent of their foreign employee compensation, and 5 percent of their foreign employment."[98] Tax rates, cross-border tax rules, and other country-specific features can attract real and artificial multinational profits, which are lumped together in Figure 3 and Figure 4. Estimates of artificial profit shifting must distinguish between the real behavioral responses to tax rates and artificial shifting purely for tax avoidance.[99]

Relying on data similar to what was described in the previous section, the empirical literature on profit shifting faces the same definitional and measurement difficulties. An additional methodological challenge is that profit shifting cannot be directly observed but must be measured using imperfect proxies and assumptions about corporate behavior in a counterfactual world, absent jurisdictional differences. These issues make the estimates in the literature highly

Figure 4

Tax haven share of total foreign and domestic US corporate profits is small and declining

Share of total US foreign and domestic profits in seven major tax havens, percent



Sources: “US Direct Investment Abroad: Balance of Payments and Direct Investment Position Data,” Bureau of Economic Analysis (BEA), last modified July 20, 2023; “US Direct Investment Abroad (USDIA),” BEA, last modified November 17, 2023; “Table 6.17C. Corporate Profits before Tax by Industry,” National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; “Table 6.17D. Corporate Profits before Tax by Industry,” National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; “Table 6.19C. Corporate Profits after Tax by Industry,” National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; “Table 6.19D. Corporate Profits after Tax by Industry,” National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; and author’s calculations.
Note: The seven tax havens are Bermuda, the Cayman Islands, Ireland, Luxembourg, the Netherlands, Singapore, and Switzerland.

imprecise. For example, despite a large body of work on the topic, research typically struggles to explain more than 20 percent of the variation in firm-level effective tax rates.[100]

Estimates of profit shifting typically apply econometric techniques to determine differences in profitability that are explained by observable factors, and the unexplained residual is attributed to profit shifting. This general approach can be applied to firm-level microdata or aggregate, country-level data. Firm-level studies tend to find significantly smaller amounts of profit shifting compared to country-level analysis. Part of this difference may be driven by inadequate coverage of tax haven profits in some firm-level sources. On the other hand, country-level data bias results upward by double-counting some income and overattributing profits to tax havens.

In a meta-analysis of the empirical literature, German economists Jost Heckemeyer and Michael Overesch find that the semi-elasticity of pre-tax income reporting by subsidiaries (a measure of how much income changes in relation to tax rates) is likely between 0.5 and 1.0, with a preferred estimate of 0.8.[101] A semi-elasticity of 0.8 means that a multinational with operations in two countries, with a 10-percentage-point difference in tax rates between countries, will increase the reported income of the lower-tax affiliate by about 8 percent of what it would have been if tax rates were the same in both jurisdictions.

Because firms tend to be more reluctant to shift income away from their headquarters, even if located in a higher-tax jurisdiction, profit-shifting estimates can be larger when the affiliates face higher tax rates than the headquarters. For policymakers in the United States, which is home to a higher portion of multinational headquarters than any other country, knowing the estimate for profit shifting between headquarters and foreign low-tax subsidiaries may be

more informative. Economists Dhammika Dharmapala and Nadine Riedel estimate the semi-elasticity between high-tax parents and low-tax subsidiaries at about 0.5, the lower end of the usual range.[102]

All the estimates reported above rely on data from firm behavior under older tax regimes, with higher tax rates and less sophisticated anti-abuse rules. Using more recent data, a 2023 working paper by Jaqueline Hansen, Valeria Merlo, and Georg Wamser of the University of Tübingen uses changes in CFC rules to estimate a semi-elasticity of about 0.2.[103] This relatively small effect corroborates the data presented in Figure 4, showing that tax havens' share of total US corporate income is relatively small.

Multinationals Pay Higher Effective Tax Rates

The moderate magnitude of tax haven profits is confirmed by other data reported directly by publicly traded US corporations. Using Compustat data from 1988 to 2017, Scott Dyreng of Duke University and Michelle Hanlon of MIT report cash effective tax rates for publicly traded nonfinancial, non-utility multinationals and domestic-only US corporations.[104] Figure 5 shows that multinationals' one-year average effective tax rates are 3 percentage points higher than those paid by purely domestic firms. The multinational-domestic effective tax rate gap remains clear across multiple measures but closes somewhat after averaging firm tax rates over multiple decades to account for annual fluctuations.

> "A significant portion of tax haven income is associated with real investment activity."

If multinationals could significantly exploit the benefits of shifting profits to tax havens, this advantage should theoretically result in a lower effective tax rate than those paid by entirely domestic firms without access to low-tax jurisdictions. However, the data show the opposite, with multinationals paying higher average tax rates, especially in the short run.

The higher cash effective tax rates are partly explained by multinationals having a more limited ability to shift income to countries with low or no corporate income tax than is popularly thought. Summarizing BEA data, University of Michigan economist James Hines notes that "slightly fewer than 50 percent of US multinational firms had any tax haven affiliates in 2014."[105] If firms could costlessly set up foreign affiliates to shift income to avoid paying taxes in high-tax countries, we would expect near-universal use of low-tax foreign affiliates. Hines concludes that this pattern "implies that the problem of tax-motivated income reallocation is modest in magnitude."[106] The lower rate for domestic firms and the closing of the tax rate gap over time may also be explained by compositional differences, such as reliance on other tax incentives like accelerated depreciation, research credits, or firm life cycle.

Revenue Loss from Profit Shifting Is Small

A subset of the profit-shifting literature attempts to estimate lost corporate income tax revenue from profit shifting by applying estimated empirical profit-shifting elasticities to existing tax rate differentials and global profit location. Using various methods and techniques, the lost-revenue estimates due to profit shifting vary widely.

For example, Clausing estimated that the United States lost between $77 billion and $111 billion of corporate income tax revenue in 2012, the high end representing about 46 percent of corporate tax collections.[107] Attempting to correct for double counting in the BEA data, as described above, Blouin and Robinson replicate Clausing's estimates and find an estimated revenue loss of $10 billion or about 4 percent of corporate tax collections.[108] Danish government economists Thomas Tørsløv and Ludvig Wier and UC Berkeley professor Gabriel Zucman use a different method that still likely overstates profit shifting to estimate US revenue loss at 14 percent of corporate tax revenue and total nonhaven losses at 9 percent.[109] Thus, due to double counting and other data issues, US revenue loss from profit shifting is likely far less than 14 percent of corporate revenue and more likely to be closer to 4 percent. Because the corporate tax raises about 10 percent of federal revenue, even a 14 percent reduction in the corporate income tax is only 1.4 percent of total federal revenue.

While policymakers might instinctively want to curtail all profit shifting to low-tax jurisdictions, some level of profit shifting should be expected and desirable. Both

private and public sectors incur substantial costs in the enforcement of tax laws. Businesses face costs that divert resources from productive investment or innovation when they must comply with burdensome rules and defend complex financial planning decisions (of which tax planning is only one consideration).[110] For governments, rigorous enforcement requires significant administrative resources for which there are diminishing returns. Often, the private and public costs of increasing tax enforcement outweigh any benefits that might come from governments—rather than the private sector—controlling the new revenue.

Higher Taxes Mean More Profit Shifting

The rise of profit shifting follows the increasing globalization and sophistication of international capital markets. In the United States, these economic trends were exacerbated by a widening gap between the combined state and federal US corporate tax rate and the OECD average corporate tax rate.

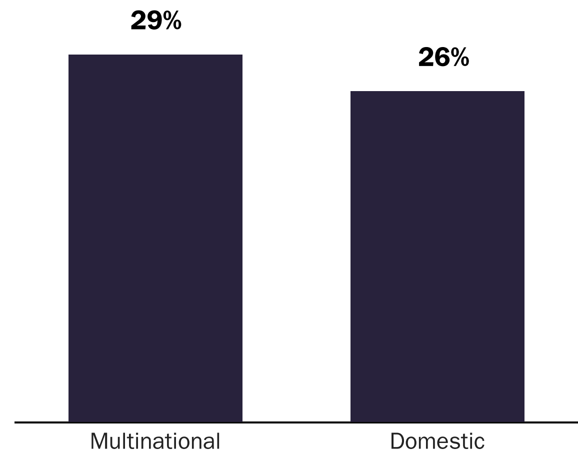
As other countries cut their tax rates to attract business activity, the United States was left with the highest corporate tax rate in the developed world by 2017.[111] When Congress cut the federal corporate tax rate from 35 percent to 21 percent, it brought the United States into line with the rest of the world. Across multiple measures of profits, the trend of increasing tax haven income reversed around the time of the near closing of the 14-percentage-point gap between the US corporate tax rate and our largest trading partners. Figure 6 shows the difference between the US combined corporate tax rate and the OECD average, with haven profits as measured by DII, and adjusted PTI as a share of total US corporate profits.

The trend shift in haven profits is consistent with multiple analyses of the 2017 Tax Cuts and Jobs Act (TCJA) that found the law decreased incentives to shift profits overseas, especially for intangible investments.[112] International business tax structures can take time to unwind. As measured by DII, profit shifting leveled off in 2018 and fell precipitously in 2020 and 2021. Any major trend break around the 2020 pandemic should be interpreted with caution, but profit shifting as measured by adjusted PTI began trending down in 2019, the year before the pandemic disruptions. The data suggest that a lower corporate tax rate is one of the most effective reforms to reduce profit shifting.

Figure 5

Domestic firms pay lower effective tax rates than multinationals

One-year average cash effective tax rates by firm type, percent, 1988–2017



Source: Scott Dyreng and Michelle Hanlon, "Tax Avoidance and Multinational Firm Behavior," in *Global Goliaths: Multinational Corporations in the 21st Century Economy*, eds. C. Fritz Foley, James R. Hines Jr., and David Wessel (Washington: Brookings Institution Press, 2021), Table 10-1.

THE REAL IMPACTS OF PROFIT SHIFTING

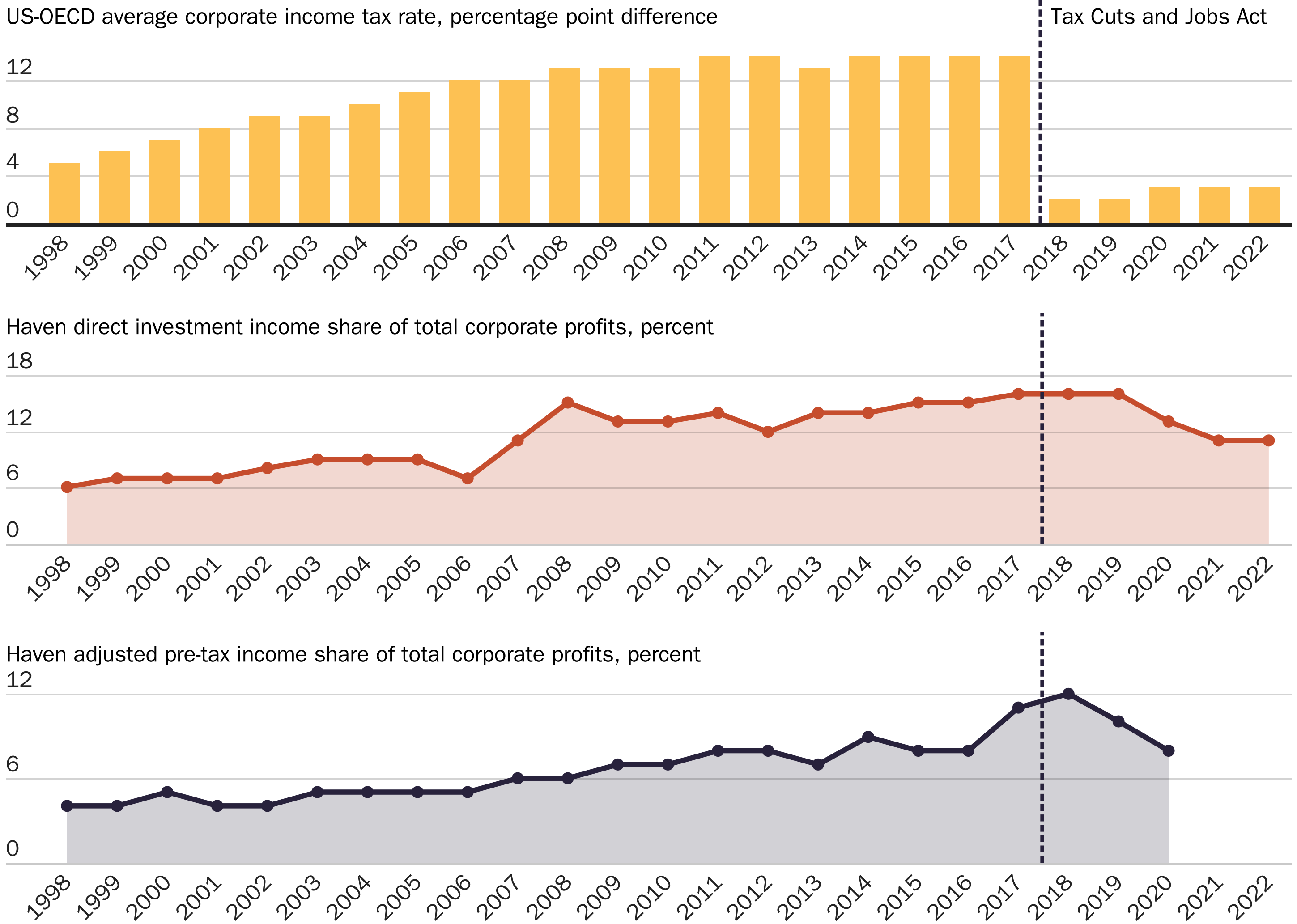
Countries compete for international investment because of the domestic economic benefits it brings. Investment in low-tax countries and tax havens also produces real economic benefits for the multinational's home country.

Low-tax countries are often derided for either attracting illusory corporate profits without changing investment behavior or for diverting international investment from higher-tax countries. However, research consistently finds that foreign business investment in low-tax jurisdictions is associated with additional complementary domestic investments that lead to higher employment levels and wage growth in multinational firms' home countries. This body of research indicates that access to tax havens—even if it just shifts paper profits—acts like a tax cut on investment that increases investment everywhere, even in nonhavens.

On the other hand, limiting access to—or forcing higher taxes on—low-tax jurisdictions can have real costs to global investment and employment.

Figure 6

Haven profit share of total US corporate income declines with corporate income tax rate cut



Sources: "US Direct Investment Abroad: Balance of Payments and Direct Investment Position Data," Bureau of Economic Analysis (BEA), last modified July 20, 2023; "US Direct Investment Abroad (USDIA)," BEA, last modified November 17, 2023; "Table 6.17C. Corporate Profits before Tax by Industry," National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; "Table 6.17D. Corporate Profits before Tax by Industry," National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; "Table 6.19C. Corporate Profits after Tax by Industry," National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; "Table 6.19D. Corporate Profits after Tax by Industry," National Income and Products Accounts, National Data, BEA, last revised September 29, 2023; "Revenue Statistics—OECD Countries: Comparative Tables," OECD.Stat; "Table II.1. Statutory Corporate Income Tax Rate," OECD.Stat; and author's calculations.
Notes: OECD = Organisation for Economic Co-operation and Development; average corporate tax rate combines national and subnational taxes; data for 34 OECD countries with consistent historical data; the seven tax havens are Bermuda, the Cayman Islands, Ireland, Luxembourg, the Netherlands, Singapore, and Switzerland.

Tax Havens Boost Real Investment

Economists have long recognized the symbiotic relationship between foreign and domestic investments, most often described as the mutual benefit of international trade and specialization. In an important 2005 paper, economists Mihir Desai and Fritz Foley of Harvard and James Hines of the University of Michigan illustrate this dynamic, estimating that "an additional dollar of foreign capital expenditure is associated with 3.5 dollars of domestic capital expenditures by the same group of multinational firms."[113] Subsequent research has shown that the complementarity of foreign and domestic investments by multinational firms remains robust even when considering investments in low-tax countries.

For example, a 2004 working paper by Desai, Foley, and Hines shows that corporate activity in low-tax countries

"does not appear to divert activity from non-havens, as the estimates imply that firms establishing tax haven operations expand, rather than contract, their foreign activities in nearby" higher-tax countries. They conclude that "the ability of foreign investors to use tax havens in the same region has the beneficial effect of stimulating investment."[114]

Using a 2006 change to a tax exemption for income originating in US territories, Juan Carlos Suárez Serrato of Stanford shows that the effective tax increase reduced foreign and domestic investment with measurable effects on American workers' well-being. Firms operating in Puerto Rico and exposed to the tax increase "reduced their global investment by 10%, increased their share of investment abroad by 12%, and reduced their US employment by 6.7%." Regions of the United States mainland that had more firms affected by the tax increase "experienced relative decreases in income, wages, and home values, and these areas also became more reliant on government transfers."[115] Cutting off access to a popular low-tax jurisdiction reduced affiliated domestic economic activity.

> "Foreign business investment in low-tax jurisdictions is associated with additional complementary domestic investments."

Countries can also increase the cost of accessing low-tax countries by requiring new forms of tax reporting. These stricter regulations reduce domestic investment and make firms less likely to invest in new global opportunities. The introduction of country-by-country reporting requirements of more detailed geographic information on business, financial, and tax activities is estimated to have had an effect equivalent to a tax increase of between 1 percent to 2 percent on affected firms.[116] Lisa De Simone of the University of Texas at Austin and Marcel Olbert of the London Business School find that the country-by-country reporting requirements made firms less sensitive to new investment opportunities, confirming a similar finding by Martin Jacob, Kelly Wentland, and Scott Wentland following a new IRS reporting requirement of uncertain tax positions beginning in 2010.[117] Following stricter transfer pricing rules that made it harder for multinationals to move profits to low-tax jurisdictions, firms decreased domestic home-country investment but did not lower total global investment.[118]

Reducing domestic taxes on foreign-earned income also increases foreign investment without crowding out domestic investment. Following the United Kingdom's move to a territorial tax system in 2009, which lowered taxes on foreign profits earned by domestic firms, Li Liu finds that UK businesses increased foreign investment in low-tax countries by almost 17 percent without offsetting reductions in domestic investment.[119]

Complementary research shows that increased foreign employment is not associated with widespread declines in domestic employment and often increases it. Georgetown University economist Lindsay Oldenski concludes in a summary of the literature that there is "no evidence of widespread replacement of US jobs with foreign jobs. However, research has shown that the effects of offshoring are heterogeneous."[120] One estimate by Oldenski, Brian Kovak of Carnegie Mellon, and Nicholas Sly of the Kansas City Fed shows that a 10 percent increase in firm-level foreign affiliate employment drives a commensurate domestic employment increase of 1.3 percent. The results hold in the aggregate data, showing substantial job reallocation but net employment gains from increased offshore activity.[121]

This body of research indicates that access to tax havens acts like a tax cut on investment that increases investment everywhere, including in nonhaven jurisdictions. Rather than a global scourge that erodes the tax base of high-tax countries, low-tax countries help allocate global capital in the face of inefficient tax systems to the benefit of workers and investors around the world. Cutting off domestic business access to low-tax countries is a lose-lose; it hurts real foreign and domestic economic activity.

AT A CROSSROADS: REFORMS FOR US INTERNATIONAL TAX POLICY

International tax policy and US tax policy are each at a crossroads. The OECD's decades-long work toward a more centralized global tax system has reached a pivotal point where dozens of countries have begun implementing the Pillar Two minimum tax, and the OECD continues to make progress toward implementing Pillar One. In 2026 the Pillar Two 20 percent statutory rate safe harbor expires, along

with scheduled effective rate increases to GILTI, FDII, and BEAT. These international deadlines coincide with the expiration of the 2017 individual tax cuts under the TCJA and numerous other fiscal policy deadlines.[122] These deadlines will force congressional action, but there are different paths Congress could take.

The following sections summarize President Biden's proposed reforms, review how congressional Republicans are currently engaging on international tax, and discuss other options, from modest reforms to bolder actions that Congress should consider.

President Biden's 2024 Budget

In addition to raising the federal corporate income tax rate to 28 percent, President Biden's 2024 budget proposal describes several significant changes to the tax treatment of foreign income.[123] The White House projected that the international tax changes would raise more than $1 trillion over 10 years, the budget's second-largest new revenue source after the higher corporate tax rate. The revenue estimates are overstatements, given the negative effects of higher taxes on investment and the unrealistic assumption that other countries would not raise their own taxes under Pillar Two. The president's proposals are intended to align the United States with OECD Pillar Two by modifying GILTI, replacing BEAT with a UTPR, and repealing FDII.

> "Low-tax countries help allocate global capital in the face of inefficient tax systems to the benefit of workers."

The president's reformed GILTI tax would have a number of significant changes, including: 1) the tax would be computed on a country-by-country basis, 2) the rate would increase to between 21 percent and 22.1 percent, 3) the Qualified Business Asset Investment deduction would be eliminated, and 4) the FTC haircut would be lowered to 5 percent. Replacing BEAT, the new United States UTPR would apply to the US subsidiaries of foreign multinationals that pay an effective tax rate below 15 percent on their overseas earnings.[124] The budget proposes replacing FDII with a 10 percent tax credit for moving active foreign jobs related to a trade or business to the United States, and tightening rules for intracompany debt deductions, among other reforms.

The 2024 budget represents an evolution of Democrats' international tax proposals. In 2021 the House Ways and Means Committee passed the predecessor to the Inflation Reduction Act (known at the time as the Build Back Better Act) with changes similar to those in the 2024 budget, with notable exceptions, such as not repealing GILTI's investment deduction, a modified rather than repealed FDII, and a 26.5 percent corporate rate.[125] In response to objections from the Senate—most notably Senator Kyrsten Sinema—the Ways and Means international proposals aligning with Pillar Two were abandoned.

Adopting a version of the OECD-recommended Pillar Two taxes at higher tax rates, as the Biden administration proposes, would come with high economic costs to US multinationals and their American workers. It also would open the US Treasury to potentially large tax revenue losses as taxable profits could face strong incentives to be shifted to other countries.

House Republican Proposals

In response to the Biden administration's negotiations with the OECD and the resulting agreement on Pillar Two, Republican members of the Senate Finance Committee and House Ways and Means Committee have expressed frustration with the process by which the deal was negotiated and the proposal's substance. The Senate has a constitutionally stipulated role in advising and consenting to treaties, while all bills changing tax law must originate in the House of Representatives. In the current political environment, it is unlikely that a tax treaty or tax law revision implementing the OECD proposals could garner enough votes in either chamber. This reality has not stopped the administration from being heavily involved in advancing and shaping the OECD process.

In addition to holding hearings and writing letters of admonition to the Treasury Secretary, Ways and Means Committee Republicans introduced two different versions of legislation that would impose higher taxes on individuals and businesses based in countries that impose extraterritorial taxes on American companies, specifically

targeting countries implementing UTPRs and digital services taxes. The first proposal is an escalating penalty that, after five years, would impose a 20 percent tax on US profits and earnings of noncitizen, nonresident foreign companies and individuals based in countries imposing extraterritorial taxes.[126] The second proposal similarly would target foreign-owned businesses in countries imposing extraterritorial taxes by modifying BEAT to increase taxes paid under the minimum tax.[127]

The Republican proposals strongly signal to other countries that the United States Congress does not support the Pillar Two proposal. Given that the OECD minimum tax is viewed around the world as a fait accompli, it is essential to send a firm message that the proposal cannot pass Congress. However, these proposals operate more like tariffs, in that the ultimate incidence of higher taxes on US subsidiary income would likely fall on American consumers. The proposal's success as a matter of international politics is also uncertain. President Donald Trump's threat of similar retaliatory actions on French companies in 2019 was unsuccessful in stopping the advance of digital services taxes or the OECD process. However, the threat of retaliation successfully changed French policy toward American-owned foreign subsidiaries in the 1930s.[128]

Allowing the OECD process to move forward, while doing nothing to change domestic tax rules, would result in both automatic tax increases on American businesses and less tax revenue collected by the US Treasury. The new OECD tax regime, layered on top of the existing US tax rules, would require businesses to comply with multiple complex tax systems, with conflicting incentives and different income definitions and reporting rules.

Framework for Capitulating to the OECD

Short of wholesale adoption of the OECD-recommended Pillar Two taxes, Congress could piece together a legislative response to mitigate the worst effects of the proposal. The centerpiece of this strategy is remaining engaged with the OECD process to secure concessions that bring existing US tax provisions into compliance with Pillar Two. Most importantly, this would require recognition of GILTI as a qualifying Income Inclusion Rule (IIR) and favorable categorization of nonrefundable tax credits, especially those for R&D.[129] This diplomatic work could also be paired with several legislative changes to adopt portions of the OECD's framework. These could include converting the Corporate Alternative Minimum Tax (CAMT) into a Qualified Domestic Minimum Top-Up Tax (QDMTT) and reforming the R&D credit to fit the OECD's criteria.[130]

Working within the OECD process would give US policymakers a seat at the table to ease some of the most economically costly pieces of Pillar Two. Furthermore, it would give the process additional legitimacy, ensuring that the project moves forward and making it harder to gain the desired concessions. Treasury Secretary Janet Yellen has been clear that the administration's goal is to advance the OECD process as far as possible before 2026, when the TCJA expirations create a forcing mechanism for congressional adoption. Continued engagement would leave the OECD in the driver's seat and Biden administration negotiators in the same position they have been for the past three years.

> "The Republicans are sending a strong signal to other countries that they do not support Pillar Two."

Simply fixing the treatment of existing US tax laws in the OECD framework should therefore not be Congress's only goal. Capitulating to the OECD on Pillar Two also accepts the OECD's broader agenda to end international tax competition, increase effective tax rates on international business, and redistribute taxing rights away from competitive economies like the United States. Pillar Two is just the most recent attempt to implement these goals. If the US adopts Pillar Two, the OECD would be emboldened to pursue similar projects to harmonize individual income taxation, carbon taxes, and other environmental standards.

Framework for Opting Out: Increase the United States' Attractiveness as an Investment Destination

Without US participation, the OECD project is less likely to move forward. Amount A under Pillar One is most likely to end without active US participation. This may lead to additional unilateral actions by other countries, but as

demonstrated by Canada's plans to move forward with its digital services tax, the OECD is not likely to end these actions either.[131]

If other countries decide to move forward on Pillar Two without the United States, they will primarily hurt their domestic economies by increasing the costs of locating in their country. Thus, with active US opposition, the conventional wisdom that Pillar Two—particularly the extraterritorial components of the UTPR—will move forward is overstated. The fragility of the deal is even greater, given the risk of US retaliation. However, policymakers should not rely on novel retaliatory tax or trade measures as a response, since such measures would impose additional economic costs on Americans.

To increase the likelihood that the Two-Pillar framework does not move forward, Congress and the administration should explicitly reject the OECD framework and move to withdraw from OECD membership if the organization continues to advocate for higher taxes on American businesses.[132] All future tax and non-tax agreements with and aid to foreign governments should be conditioned on exempting US-based multinationals from extraterritorial taxes. The US Treasury and Congress should make clear that the United States plans to enforce existing tax treaties, which the United States could consider to be violated by extraterritorial UTPRs.[133] Domestic policy reforms to attract businesses that would be penalized in OECD-aligned countries would put further pressure on the attempted tax cartel.

Even if the OECD project moves forward, multinational firms will continue to plan their global operations to minimize effective tax rates. Modeling by the Joint Committee on Taxation and the Tax Foundation suggests that, under Pillar Two, the United States would likely benefit from additional inbound profit shifting as the global minimum tax undermines the previous advantages of locating investments in lower-tax countries.[134] Without US tax law changes, the additional inbound investment is likely not large enough to offset the lost revenue to the US Treasury from higher foreign tax credits and lower income tax collections.[135] Congress's goal should not be to maximize revenue but to maximize inbound investment. The additional investment would benefit American workers far more than the change in federal revenue.

Whether or not the OECD global tax moves forward, Congress could maximize the attractiveness of the United States as a destination for new physical investments and artificially shifted profits. The Tax Foundation ranks the United States 21st out of 38 OECD countries on international corporate tax competitiveness.[136] Corporate tax reforms could significantly improve that standing.

Even after the 2017 tax cut and reforms, the United States still has an above-average corporate income tax rate, R&D spending deductions are limited, full expensing for domestic investments is expiring, and US cross-border tax rules remain hopelessly complex. Fixing each of these items would help Congress meet two goals simultaneously. First, it would support American workers and investors by making America the most attractive place to do business in the world. Second, it would undermine the OECD global tax increase by opting out of its scheme, lowering the risk that the project moves forward as currently conceived.

> "Adopting Pillar Two would embolden the OECD to pursue similar projects to harmonize individual income taxation and environmental standards."

The most straightforward way to meet these goals is to repeal the corporate income tax. Given political constraints, however, there are ways to maintain the corporate tax while minimizing its economic costs.

Corporate tax rate. Congress should lower the federal corporate tax rate to 12 percent or lower. This would allow the federal rate to slightly undercut the Irish corporate tax rate and put the US combined state and federal rate a couple of percentage points above 15 percent. A corporate tax rate at or below the OECD minimum would attract investment and multinational headquarters from other countries, expand the US tax base through inbound profit shifting, and reduce compliance costs, especially if paired with other reforms described below.

Full expensing. While not strictly an international reform, full business expensing is critical to making the United States not just an attractive location for paper profits but also a destination for the types of physical

investments necessary to support jobs and productivity growth. Competing for physical investments with expensing could also undermine the OECD minimum tax scheme by maximizing firms' substance-based income exclusion (allowing effective tax rates to fall below 15 percent).

Full expensing, or 100 percent bonus depreciation, allows firms to deduct the full cost of new investments immediately instead of recovering the costs over time, as the standard system of depreciation and amortization requires. Spreading out the tax deductions over as many as 39 years increases effective tax rates on new investments as the deductions lose value over time.[137] The TCJA temporarily fixed this problem for short-lived investments (those with asset class lives of less than 20 years), but beginning in 2022, companies started amortizing research expenses over five years, and beginning in 2023, equipment and other short-lived investments lose 20 percent of their 100 percent expensing deduction each year through 2026, raising investment costs in the United States.

> "Congress's goal should not be to maximize revenue but to maximize inbound investment."

Congress should permanently restore full expensing for R&D expenditures and short-lived assets by making the TCJA reforms permanent. Congress should also expand expensing to longer-lived structures by allowing the same immediate deduction or implementing a "neutral cost-recovery system," which provides a similar economic benefit as expensing by enabling businesses to index their write-offs for inflation and time.[138]

Complete territoriality. While the 2017 TCJA moved toward a territorial system by implementing a dividends-received deduction, GILTI and existing CFC rules claw back a lot of the benefits of the territorial regime by subjecting a significant portion of foreign profits to immediate worldwide taxation. These rules are necessary only if the US tax rate is too high relative to other countries. Firms only shift profit until the benefits of tax planning equal the costs of the real frictions.

Policymakers should think of costly and complex cross-border tax rules as necessary only to mitigate the negative incentives of an uncompetitive corporate income tax rate. High tax rates require costly anti-base-erosion rules to keep businesses and income from moving. At lower tax rates, fewer base protections are necessary.

If other countries continue to pursue higher taxes on multinational businesses—whether through the OECD Pillar Two rules or unilaterally—a US strategy of fewer costly cross-border tax rules could be backstopped by other countries' more aggressive enforcement of their own laws. In a Pillar Two world, it may be even easier for the United States to opt out of the international tax system entirely as the risks of abuse under a territorial system would be curtailed by other countries' enforcement measures.

Most US cross-border tax rules could be repealed under a low-enough corporate tax rate and 100 percent expensing. Making the United States the most attractive investment location in the world means that most base protection rules would become unnecessarily costly. A complete territorial system would require the following steps:

- Extend the participation exemption for dividends to capital gains,
- Significantly narrow or eliminate controlled foreign corporation (CFC) rules, including repealing Global Intangible Low-Taxed Income (GILTI) and the Corporate Alternative Minimum Tax (CAMT),
- Disregard all foreign taxes paid by eliminating foreign tax credits (FTCs), and
- Repeal withholding taxes, expense allocation rules, the Base Erosion and Anti-Abuse Tax (BEAT), Foreign-Derived Intangible Income (FDII), and other extraneous cross-border rules and reporting requirements.

Expand participation exemption. Twenty-three of the OECD's 38 member countries allow 100 percent exemptions for foreign-sourced dividends and capital gains. The United States allows the deduction for dividend income only. Allowing a full deduction for foreign-sourced capital gains income would increase US multinationals' competitiveness abroad and encourage additional foreign investments and complementary investment at home.

Repeal controlled foreign corporation rules. CFC rules are designed to claw back the benefits of the participation

exemption, essentially taxing a portion of foreign income on a worldwide basis. Costa Rica and Switzerland benefit from having no CFC rules, allowing for the full benefits of the territorial tax system and dramatically simplifying tax compliance for domestic multinationals.

If full repeal is not an option, Congress should significantly narrow the definition of CFC, following the models used in places such as Ireland, Luxembourg, and Estonia, which define CFC income as applicable only to nongenuine or fictitious arrangements and provide exceptions to treaty partners and other friendly nations. This would include repealing the GILTI minimum tax rules, which are an exceptionally expansive subset of the US's CFC regime, applying broadly to both active and passive income. Similarly, the CAMT imposes a minimum tax on a different measure of worldwide income and should be repealed.

> "Costly and complex cross-border tax rules are necessary only to mitigate the negative incentives of an uncompetitive corporate income tax."

Repeal foreign tax credits. With a complete territorial tax system and no CFC income, the US could entirely disregard multinationals' interactions with foreign tax systems, including taxes paid to other countries. If the United States claims no right to tax foreign income, there should be no associated foreign tax to credit against the US tax liability. Transition rules may be appropriate as many multinationals hold FTCs as deferred tax assets, but shortsighted accounting devices should not stand in the way of broader reforms that would benefit every US multinational over time.

Repeal withholding taxes. The United States currently has the highest withholding tax rates of any OECD country at 30 percent. Following the lead of Hungary, the United States should cut withholding taxes on dividends, interest, and royalties to zero.

Repeal expense allocation rules. These rules require multinationals to allocate or reclassify a portion of domestic expenses as foreign expenses, such as interest, R&D, and certain management expenses. Under existing law, expense allocation rules interact with other provisions to impose a hidden surtax on foreign profits.

Repeal the Base Erosion and Anti-Abuse Tax. Repealing BEAT would simplify tax compliance and make the United States a more attractive investment destination by removing the tax on cross-border financing and payment structures. The BEAT becomes entirely extraneous under an internationally low corporate income tax rate.

Repeal the Foreign-Derived Intangible Income deduction. The deduction for FDII is valuable for the US tax base only if the headline corporate tax rate is higher than most other countries'. Policymakers should seek to attract all types of investments and their related income, not just those derived from intangibles. Lowering the tax rate for all corporate income would maintain the tax advantage for intangibles relative to other jurisdictions and expand those benefits to tangible investments in equipment and facilities.

Fix treatment of interest. The TCJA included a new interest-expense limitation of 30 percent of modified earnings. Beginning in 2022, the business interest deduction limit switched from 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA) to the more restrictive earnings before interest and taxes (EBIT). The tighter definition increases the cost of debt-financed investments. Republicans proposed returning to the pre-2022 EBITDA base in the American Families and Jobs Act. Keeping taxes on investment from rising is an important goal, and using EBITDA follows international norms. However, a more substantial reform to reduce profit shifting and rationalize broader portions of the tax code could include eliminating interest as a deductible expense. Such a change should be paired with eliminating or substantially lowering income taxes on interest income to minimize multiple layers of tax on the same income.

Stop information exchange and reporting. Without information from other countries and financial institutions about foreign transactions and economic activity, it is more difficult to enforce extraterritorial taxes on overseas profits. Congress should repeal the Foreign Account Tax Compliance Act (FATCA) of 2010, country-by-country reporting requirements, and, where possible, stop taxpayer information exchange programs with any country implementing Pillar Two.

Repeal worldwide individual taxation. The United

States is one of the few countries that taxes its citizens on worldwide income, regardless of where they live. This approach discourages global mobility and professional opportunities for Americans abroad. Shifting to a territorial system for individual taxation would align the United States with international norms, reduce the administrative burden on expatriates, increase the competitiveness of American companies abroad, and likely attract global talent to contribute to the American economy.

CONCLUSION

In an era marked by global trade and digital transformation, the international tax landscape is at a crucial juncture. While framed as a solution to contemporary challenges, the OECD's Two-Pillar proposal threatens to stifle the diversity and competition that have been hallmarks of the international corporate tax system. American policymakers stand at a crossroads, facing a decision to either conform to a global standard that will increase business taxes and diminish national autonomy, or prioritize making the United States a beacon for international business investment.

As the world evolves, it is imperative for tax policies to adapt in a manner that upholds economic dynamism, encourages innovation, and maintains jurisdictional competition. Congress has a unique opportunity to craft a reform that caters to the present challenges and anticipates the needs of the future, setting a standard for the rest of the world to follow.

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64. David M. Schizer, Testimony before the Subcommittee on Tax of the House Ways and Means Committee, at "Biden's Global Tax Surrender Harms American Workers and Our Economy" hearing, 118th Cong., 1st sess., July 19, 2023.

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67. Adam N. Michel, "OECD Rules Risk Fueling Competition for State Subsidies," Geopolitical Intelligence Services, December 12, 2023.

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rest of the world still follow almost identical trends and levels, with small discrepancies in a few years.

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129. Excluding home-country income of multinationals (or for those multinationals in countries where the statutory rate is above 15 percent) could mitigate the worst effects of Pillar Two.

130. The primary difference between the OECD minimum taxes and the US regime under CAMT and GILTI is the OECD's application of FTCs on a country-by-country basis, versus the simpler US convention of allowing tax credits to

be blended across countries. CAMT also allows blending of profits and losses across jurisdictions and effectively rebates the tax in the future.

131. The Pillar One rules are written so countries can adopt the new tax or continue with their domestic digital services tax. Given the uncertainty around Pillar One, Canada has decided to move forward with its domestic digital tax. Countries with the most aggressive unilateral taxes have the least incentive to join the agreement. See Adam N. Michel, "OECD's Pillar One: A Step toward Chaos Rather Than Stability," *Cato at Liberty* (blog), Cato Institute, October 30, 2023.

132. To withdraw from the OECD, Congress must instruct the president to immediately notify the depository government (the government of France, where the OECD is based) under Article 17 of the Convention on the Organisation for Economic Co-operation and Development that the United States will terminate the application of the Convention and the Convention's protocols. Withdrawal from the OECD should be paired with a prohibition on any US funding for the OECD in future budgets.

133. Mindy Herzfeld suggests: "If Treasury or Congress were to set out reasoned arguments why application of the UTPR violates tax treaties and clarify that US rights would be asserted under those treaties if other countries sought to apply the UTPR to the profits of US multinationals, that could have the effect of reducing adoption of the UTPR." Mindy Herzfeld, "Is There a Way to Fix Pillar 2?," *Tax Notes International* 111 (July 17, 2023): 259.

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