Economic Effects of Limits on Base Erosion with Outbound Investment

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Profit Shifting Incentives

- Tax rate and base differentials drive profit shifting incentives
- Host and home governments as well as intergovernmental organizations (OECD) can attenuate or amplify the incentive effects
- Income shifting is not driven only by differentials between statutory rates
  - Presence of tax havens enhances income shifting opportunities
  - Ability to arbitrage differences in tax systems (BEPS has made this much harder)
  - “Special” rates created by patent and innovation boxes change benefits of shifting intangibles and IP income (BEPS has made adopting these preferential regimes more difficult)

Statutory tax rate differentials

- Play no role if we have a worldwide system with current taxation (no deferral)
- Do play a role if worldwide taxation is paired with deferral
  - Creates incentives for income shifting
  - Power of incentives depends on effective repatriation tax rate, foreign tax credit positions, transfer pricing rules, etc.

Previous system

- Effectively a hybrid between territorial and worldwide **with a high statutory rate**
  - Income shifting incentives abounded
  - Different types of income subject to different rules
    - Subpart F, export source, active finance, etc.
  - Check the box effectively lowered tax rates on investment abroad increasing the tax differential and amplifying shifting incentives

Tax Reform of 2017

- Significantly lowered the statutory rate
  - Decreases tax rate differentials and, as a result, decreases shifting incentives
- Moves to territorial
  - Incentives created by tax rate differentials no longer dampened by repatriation tax
- But is still very much a hybrid!
  - Paired with base erosion provisions to protect the base
  - Adopts minimum tax approach (GILTI) → territorial for low-return income but worldwide with current taxation for high-return income
  - Adopts preferential tax regime for foreign derived intangible income (FDII)
  - Imposes add-on base erosion and anti-abuse minimum tax (BEAT)
  - Different types of income subject to different rules
  - Retains check the box

What does a minimum tax do?

- First: why impose it?
  - Takes as starting point that transfer pricing regulations don’t work
- Reduces power of tax rate differentials (*which have already been substantially decreased*)
- Grubert and Altshuler considered a set of minimum tax proposals and compared to the pre-2018 system with a 30% U.S. statutory rate
  - “Fixing the System”, *National Tax Journal*, September 2013

Grubert and Altshuler
Effective Tax Rate Simulations

- Show impact of proposals on investment location, income shifting, repatriation planning, and revenue
- Two foreign countries, one with a 5% tax rate, another with 25% and the U.S. with 30%. Also a pure tax haven.
- A discrete high tech investment in low-tax country based on U.S. R&D. Also a routine investment in high-tax location. Routine investment has 10% normal return.

Simulations (cont.)

- Considers alternative systems for international reform including dividend exemption.
  - Models impact of different base erosion provisions including a per country and an overall minimum tax (at a rate of 15%)
  - Includes options allowing expensing (in simulations, modeled as a deduction of normal return of 10% for the purpose of the minimum tax)
- Assume cost of shifting intangible income from the U.S. is a quadratic function of the amount shifted relative to the investment
  - Calibrated based on profitability and royalties paid in low-tax countries
- Assume burden of the repatriation tax in low-tax country under current law is 5 percent of income

Effective Tax Rate Simulations

Tax parameters:

U.S. rate = 30%

Minimum tax rate = 15%

Low-tax investment in country with 5% rate

High-tax investment in country with 25% rate

Effective Tax Rate Simulations

Low tax investment	
Pre-2018 law	-.236
Dividend exemption	-.295
Overall minimum tax with expensing (for parent with ETR<15%)	-.040
Overall minimum tax with expensing (for parent with ETR>15%)	-.295
High tax investment	
Pre-2018 law	.130
Dividend exemption	.107
Overall min tax with expensing (for parent with ETR<15%)	.000
Overall minimum tax with expensing (for parent with ETR>15%)	.107

Tax parameters:

U.S. rate = 30%

Minimum tax rate = 15%

Low-tax investment in country with 5% rate

High-tax investment in country with 25% rate

Simulation Results

- Opportunity for income shifting results in a large tax subsidy for investing in low tax country
- End of repatriation tax under dividend exemption pushes ETR further into negative territory
- Under the overall min tax with expensing modeled, all additional income is taxed at 15% if the parent is below the threshold
  - There is no longer any incentive to shift foreign income to the haven or from the high-tax country to the low-tax country
  - But what we modeled is not GILTI!

Compare to New System

- Tax rate differentials substantially reduced
  - ETRs under dividend exemption will increase
- But GILTI is not an overall minimum tax with expensing!
  - Deduction is not for normal return. Deduction of 10% of the adjusted base of tangible property (less certain interest expense). Different investment and income shifting incentives than if allowed expensing.
  - Is it hitting only mobile income? How well is it targeted? What about services income? (Defining mobile income is fraught with problems)
  - 80% haircut of foreign tax credits. (Preserves incentive to lower foreign tax payments.)
  - Includes expense allocations and, as a result, is not a “minimum tax”
- All of these design considerations will impact behavior (and possibly with unexpected consequences)

Expense Allocations under GILTI

- Previous system expense allocation rules were carried into new system

- Expense allocations in GILTI basket increase taxes on GILTI income
  - Allocations reduce the foreign tax credit limitation
  - Parents can end up paying tax on GILTI income even if foreign income tax on tested income is greater than 13.125%

Foreign Derived Intangible Income (FDII)

- The “carrot” – a 13.125% rate on “foreign derived intangible income”
- Does it neutralize decision as to where to place intangibles? (Answer: No, but it does narrow the gap between benefits of keeping IP used in connection with foreign market sales at home versus placing it abroad)
- How much of deemed intangible income is export-related income?
- May not survive WTO challenge – unstable feature of new law

Understanding consequences of new law…

- …is a very much a work in progress
- Questions:
  - Impact on income shifting? Location of tangible and intangible assets? (Send tangibles abroad and keep intangibles at home?) Mergers and acquisitions? Leasing? Expatriations?
  - What are the unintended consequences?
  - Need to get to work!
- Bigger picture question: Can we control base erosion?
  - Tension between neutralizing (i) margin between investing at home and abroad and (ii) margin between headquartering at home or abroad