



Corporate Income Taxation in a Global Economy

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SUMMARY

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Corporate Income Taxation in a Global Economy

The taxation of corporate income in a global economy is arguably the most complex area of U.S. tax policy. The United States' increasing interconnection with the rest of the world through trade and financial investment and the growing importance of intangible assets make formulating corporate income tax policies more complex and yet more important to revenue and economic activity. This report presents the basic concepts of corporate income taxation in a global economy.

A starting point for understanding international corporate income taxation is determining which country has the first right to tax multinational corporate profits. The international and historical norm has been that the first right to taxation belongs to the country in which a corporation's assets are located. Another norm is that corporate income should not be subject to double taxation (i.e., two countries imposing tax on the same income). Even if the first right to tax is with the country where a corporation's assets are held, the corporation's home country may also tax income earned abroad by its resident firms after allowing for credits for foreign taxes paid to avoid double taxation. Many countries have largely territorial systems that do not generally impose taxes on income earned outside their borders except to prevent profit shifting. The United States has a minimum tax on foreign-source income: the tax on global intangible low-taxed income, or GILTI (with credits allowed for 80% of foreign taxes), which imposes a residual tax on income of foreign subsidiaries. GILTI has an exemption for 10% of tangible assets, as well as a tax rate that is lower than the regular corporate tax rate. The Organisation for Economic Co-operation and Development (OECD) and G20 have proposed a similar worldwide minimum tax for all countries to adopt, the global anti-base erosion (GLoBE) tax. (This proposal is Pillar 2 of their two-pillar approach to address base erosion.)

Three important issues affected by international tax rules are (1) the location of tangible investment; (2) profit shifting; and (3) the tax treatment of digital companies. The current system, where income from tangible investments is largely untaxed except by the country of location, often encourages investments in low-tax countries. Investment moves from the United States to lower-tax countries, which can reduce the U.S. capital stock, lower wages, and reduce economic efficiency as capital is not deployed to its best uses. These effects are likely to be small because of the importance of other factors that determine the location of production. Nevertheless, equalizing the tax rates on the return to domestic capital and foreign-located capital can reduce these effects. One way to accomplish this would be to eliminate the deduction for tangible assets from GILTI, as well as making other changes to increase GILTI taxes that affect investment in tangible and intangible assets.

Profit shifting, which one estimate indicates loses close to \$80 billion in annual U.S. corporate revenue, occurs when firms transfer the rights to intangible assets into low-tax countries. It can also occur when firms locate debt in high-tax countries, reducing income taxed in those countries and increasing it in low-tax countries. In addition to GILTI, a number of U.S. tax rules aim to limit profit shifting, including an alternative base erosion and anti-abuse tax (BEAT) that adds back certain payments to related foreign subsidiaries to the corporate tax base and taxes them at a lower rate. BEAT can address shifting of profits from U.S. parents to foreign subsidiaries and shifting by foreign parents out of U.S. subsidiaries. Several proposals are under consideration to change tax rules that contribute to profit shifting, including the House-passed version of H.R. 5376 (the Build Back Better Act). One of these proposals would increase the tax rate on GILTI. Another would impose the foreign tax credit limitations on a per-country basis so that firms could not use unused credits in countries with taxes that exceed the U.S. tax due to offset taxes in low-tax countries. A third would allocate worldwide interest deductions in proportion to the share of worldwide income. The United States would also likely benefit from the proposed GloBE tax, which would reduce the attractiveness to foreign multinationals of foreign low-tax jurisdictions compared to the United States.

There has also been interest in developing proposals to allow user countries a share of the residual tax on large multinational digital companies, which often locate subsidiaries in no-tax countries. Some countries have argued that they should have the right to tax these profits because their users create value. Some of these countries have begun to impose excise taxes on the revenues of digital companies in their country. This concept of taxing rights is inconsistent with traditional norms under which the rights to tax require some physical presence and are allotted based on the location of investment. The OECD/G20 countries (including the United States) have agreed to allocate a share of these profits under another part of their proposals to address base erosion (known as Pillar 1). Countries would agree to eliminate their digital excise taxes. The United States would likely find Pillar 1 to reduce revenues, and Congress may face decisions on whether to take action.

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The taxation of U.S. corporations within the context of the global economy is arguably the most complex area of tax policy. Tax rules in this context largely involve the taxation of corporate income (or profits), although taxes can apply to the sale of corporate products through sales taxes or value-added taxes, which are sales taxes applied at each stage of production.¹ Excise taxes may apply to certain products, typically alcohol, tobacco, and motor fuels. Recently, some countries have imposed digital services taxes that are effectively a form of excise tax. These digital excise taxes were imposed in the context of claims that some profits of digital firms should be taxed in the country of use, an issue that is under consideration. Sales, value-added, and excise taxes are designed to be imposed on a country's domestic consumption and not a corporation's profits. A few countries impose property taxes.

Economic globalization broadly refers to the increasing integration of national economies around the world, particularly through trade and financial investment flows. This process is widely agreed to have started post-World War II. The increasingly integrated global economy has raised a number of issues with how the corporate tax may affect the location of tangible investment and with properly identifying the source of corporate profits. The complex international rules largely focus on taxing corporate profits, or income, and are the topic of this report.

This report presents the basic concepts of corporate income taxation in a global economy. After a brief description of the U.S. corporate tax, the report highlights the United States' increasing interconnection with the rest of the world through trade and financial investment and the growing importance of intangible assets. The increasing interconnection with the rest of the world means that other countries affect the U.S. economy and that U.S. policies affect or are constrained by other countries' policies. The growth in intangible assets complicates the development of rules for determining the appropriate amount of tax due in different countries.

The report then reviews the basic principles of international taxation and examines three important issues raised by the increasingly interconnected nature of the global economy. Two of these issues are the traditional issues surrounding international taxation: how international tax rules can affect the location of investment and profit shifting. The third is the debate on digitalized companies and value creation, which has recently gained international attention.

Proposals to revise the international tax system that aim to reduce incentives to invest abroad and reduce profit shifting are discussed throughout the report. These proposals include several bills introduced by Members of Congress, a proposal by the Biden Administration, the Build Back Better Act (H.R. 5376) passed by the House, and the Senate Finance Committee's draft of the Build Back Better Act. The Biden Administration has also endorsed international tax proposals offered by the Organisation for Economic Co-operation and Development (OECD) and the Group of Twenty (G20). One of these proposals is aimed at reducing global profit shifting, and one would reallocate the right of taxation across countries for certain digital services.

Overview of the Corporate Income Tax

The corporate income tax is imposed on profits, or net income, of corporations. Profits are receipts minus deductions such as the cost of intermediate goods, wages, interest, and

¹ In 2016, then-House Speaker Paul Ryan proposed a "cash flow" tax that would have been equivalent to a domestic sales tax. See CRS Report R44823, *The "Better Way" House Tax Plan: An Economic Analysis*, by Jane G. Gravelle for a discussion. This proposal was not adopted and one of the major reasons is that such a tax, as in the case of a value-added tax and excise taxes, is imposed on imports (and rebated on exports). Exchange rate adjustments mean that this tax should be the same as a domestic sales tax. See CRS Report R44821, *Border-Adjusted Consumption Taxes and Exchange Rate Movements: Theory and Evidence*, by Grant A. Driessen and Mark P. Keightley for a discussion of this issue.

depreciation. The tax rate is currently 21% of profits. Credits reduce taxes and include some domestic credits (such as the research and development credit, low-income housing credits, and certain energy credits). Taxes are also reduced by credits for foreign taxes paid on foreign-source income.

Profits earned in the United States are subject to tax, including profits earned by foreign-owned corporations. Certain income derived from foreign sources is also taxed, including interest, royalties, and income earned through foreign branch operations (operations that do not involve earnings from foreign-incorporated subsidiaries). As discussed below, certain income of foreign-incorporated subsidiaries is also taxed, including Subpart F income (income that is easily shifted) and some portion of remaining income through the global intangible low-taxed income (GILTI) regime. This latter tax regime is aimed at taxing some portion of income earned abroad from intangible assets held in foreign subsidiaries.²

Major changes were made to the U.S. corporate tax in 2017 as part of the 2017 tax revision, commonly referred to as the Tax Cuts and Jobs Act (TCJA; P.L. 115-97). The corporate tax rate was reduced from 35% to 21%, and the international tax regime shifted from one where foreign income of U.S. subsidiaries was taxed only when paid as dividends (and not on income reinvested abroad) to the current GILTI regime.

Most other countries also impose corporate income taxes, although they do not generally tax income of their foreign subsidiaries as the United States does through GILTI. International tax norms are aimed at preventing double taxation of income (that is, taxation of the same income by two countries). A major focus of these norms is determining where profits are earned.

Growth in the Globalization of U.S. Economic Activity

Economic globalization broadly refers to the increasing integration of national economies around the world, particularly through trade and financial investment flows.³ This process is widely agreed to have started after World War II. The increasingly integrated global economy has raised a number of issues with how the corporate income tax may affect the location of tangible investment and with properly identifying the source of corporate profits.

As global activity increases, international tax rules become more important. Trade data indicate that the United States, like many other countries, has become increasingly interconnected with the global economy over time. **Figure 1** shows that in the post-World War II period, total U.S. trade (exports plus imports) increased as a share of U.S. gross domestic product (GDP) from 9% in 1946 to as much as 31% in 2011. The general upward trend in trade is not unique to the United States. For example, total world trade as a share of world GDP increased from 25% in 1970 to 56% in 2019.⁴ In 2020, total U.S. trade was equal to 24% of GDP, with the decrease from its height partly explained by the economic fallout from the COVID-19 pandemic (and possibly, some researchers argue, by tariffs imposed during the Trump Administration).⁵

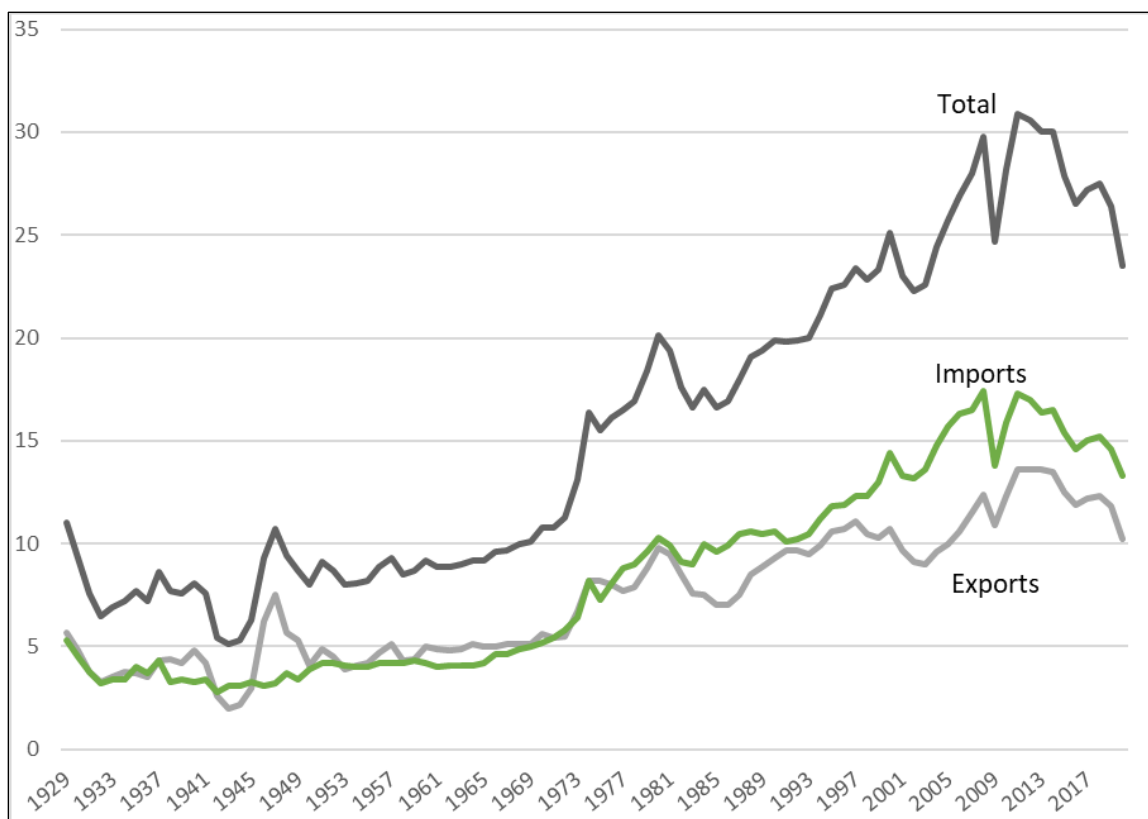
² See CRS In Focus IF11943, *GILTI: Proposed Changes in the Taxation of Global Intangible Low-Taxed Income*, by Jane G. Gravelle for an explanation of how GILTI works.

³ International Monetary Fund, *Globalization: A Brief Overview*, May 2008, imf.com <https://www.imf.org/external/np/exr/ib/2008/053008.htm>.

⁴ World Bank, <https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS>.

⁵ See Columbia School of Business, *The Real Cost of Trump's Trade War*, Chazen Institute Research Brief, 2019,

Figure 1. U.S. Total Trade as Percentage of GDP, 1929-2020

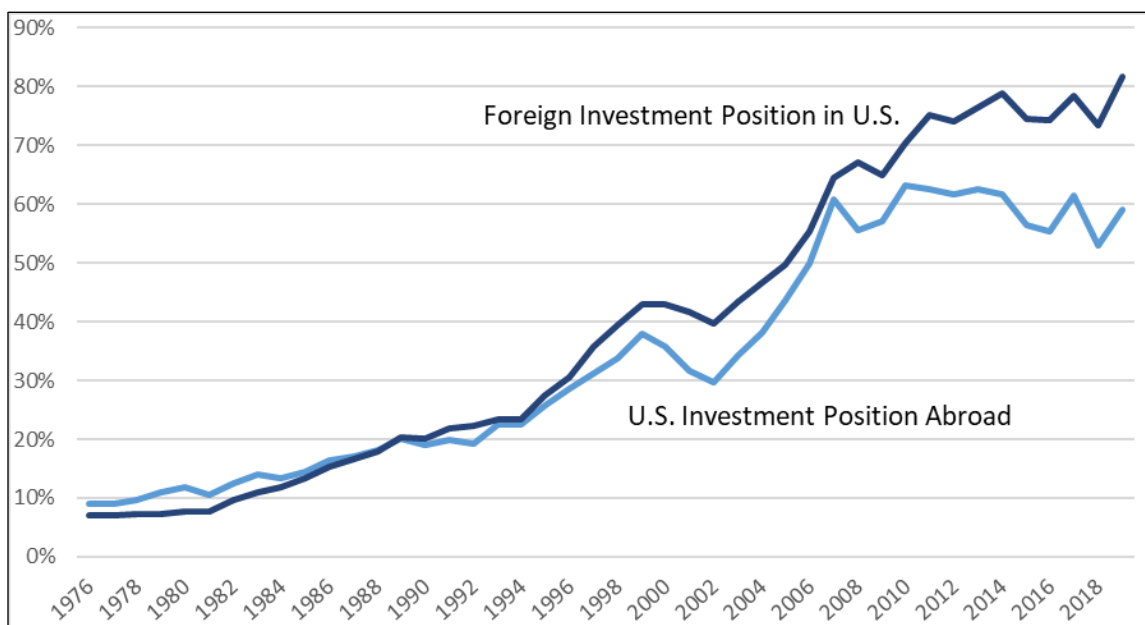


Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Data, National Income and Product Accounts, Table I.I.10.

The long-term upward trend in trade reflects increased global interconnections within and across corporations, workers, and consumers. Both U.S. corporations and subsidiaries of foreign corporations have U.S.-based production facilities that produce goods and services for export to foreign markets around the globe. Similarly, foreign corporations and subsidiaries of U.S. corporations operate abroad and export to the United States and other countries. Corporations also appear on the import side of the ledger, relying on imported machines, raw materials, and inventories for use in production or for resale. Workers contribute to the research, design, and production of goods and services for export, often in combination with imported inputs. Consumers purchase imported goods and services, seeking variety and low prices. Imported capital goods and industrial supplies and materials used in production generally exceed (combined) the value of imported consumer goods. For example, in 2020, imported capital goods totaled \$734 billion and imported industrial supplies and materials totaled \$653 billion, while consumer goods imports were \$741 billion.

https://www8.gsb.columbia.edu/chazen/sites/chazen/files/chazen-research-brief-Real-Cost-of-Trump-Trade-War-030719_v3.pdf.

Figure 2. U.S. International Investment Position as Percentage of Fixed Private Capital Stock, 1976-2019



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Data, Fixed Assets, Table I.1 and International Data, International Transactions, International Services, and International Investment Position, Table I.1.

The United States' increasing interconnection with the global economy is also visible in international investment data. **Figure 2** displays foreigners' investment position in the United States as a share of the U.S. fixed private capital stock.⁶ Foreigners' investment position represents claims on U.S. assets, and as a percentage of the fixed private capital stock increased from 7% in 1976 to 82% in 2019.⁷ Likewise, the U.S. investment position represents claims on assets in other countries, and this figure increased from 9% to 59% (as a share of the fixed private capital stock) over the same time period. The increase in both foreign claims on U.S. assets and U.S. claims on foreign assets has been driven primarily by the increase in portfolio investment as opposed to direct investment. Portfolio investment represents equity and debt investments without a controlling interest, whereas direct investments are those constituting 10% or more ownership or controlling interest.⁸ Portfolio investment is generally passive, while direct investment is generally active.

⁶ The U.S. fixed private capital stock consists of the current cost-depreciated value of all fixed assets that are used in the production of other goods (including other fixed assets) or of services for more than one year. These assets include equipment, structures, and intellectual property.

⁷ These figures should not be interpreted as implying that foreigners provided, for example, 82% of the financing for private U.S. investment. The investment position data are expressed as a share of the fixed private capital stock to account for the fact that international investment positions should increase over time as the capital stock increases with the size of the economy.

⁸ U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. International Economic Accounts: Concepts and Methods*, July 2021, <https://www.bea.gov/system/files/methodologies/ONE%20PDF%20-%20IEA%20Concepts%20Methods.pdf>.

The Growing Importance of Intangible Assets

The growing importance of intangible assets, also known as *intellectual property*, is increasing the complexity of corporate taxation. Intangible assets include drug formulas, technology for computers and cell phones, algorithms for search engines, and websites. Firms with brand name recognition also hold the rights to those brand names via trademarks. Unlike a factory, which has a physical location, intangible assets involve rights. Firms may develop intangible assets in the United States and export the goods with intangible embedded assets (such as drugs and cell phones) or provide the intangible asset to foreign customers (such as making available a free search engine that is financed by advertising). Companies may also sell the rights to produce goods with intangible embedded assets abroad by charging royalties or by selling the intangible asset to foreign firms, which usually are related foreign-incorporated firms.

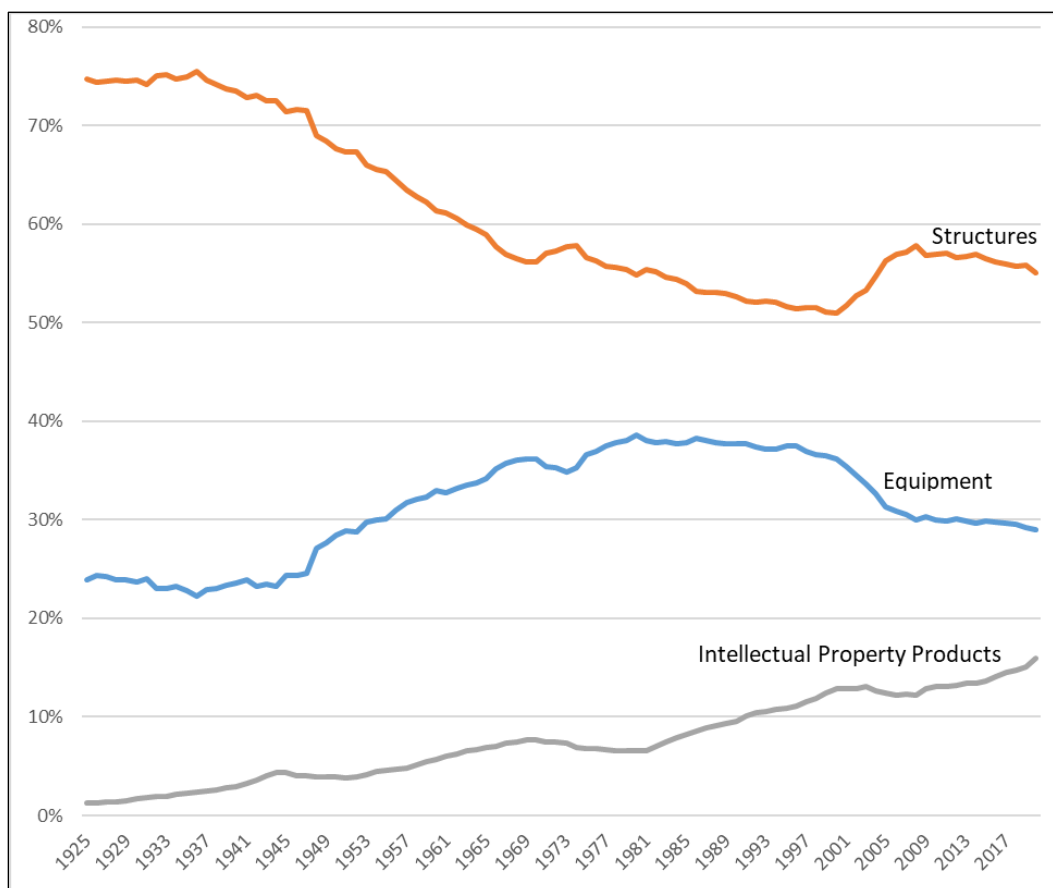
Specifically, intangible assets complicate the measurement of profit generated in different countries and therefore the appropriate amount of tax due in those countries. The complication stems from the uniqueness of intangible assets and lack of reference to market values. This makes it difficult to enforce rules specifying how the transfer of intangible assets or the rights to them between foreign related entities should be valued for purposes of profit and tax determination (known as *arms-length transfer pricing rules*).

Bureau of Economic Analysis (BEA) data provide one means of quantifying the growing importance of intangible assets, through a measurement of intangible assets that is consistent but not comprehensive.⁹ **Figure 3** displays a breakdown of the BEA's data on the nonresidential corporate capital stock by type—structures, equipment, and intellectual property products (IPP)—from 1925 to 2020. The BEA's measure of intellectual property products includes software; research and development; and original entertainment, literary, and artistic productions. BEA data do not allow for separate analysis of C corporations, which are subject to the corporate income tax, and S corporations, which are not subject to the corporate income tax.¹⁰

⁹ Compiling a comprehensive statistic on intangible assets is complicated by definitional issues. For example, while it may be straightforward to define what is a patent for a new prescription drug or identify the computer code underlying a piece of software, it is less clear how to define production synergies between company divisions. Likewise, quantifying the value of intangible assets is complicated by measurement issues (similar to the profit measurement issues mentioned above). For example, how should a company's brand recognition or reputation be valued? Or, what is the value of a new drug that has not been brought to market?

¹⁰ See CRS Report R43104, *A Brief Overview of Business Types and Their Tax Treatment*, by Mark P. Keightley for an explanation of forms of business operation, including Subchapter S.

Figure 3. C and S Corporate Nonresidential Capital Stock by Type, 1925-2020



Source: U.S. Department of Commerce, Bureau of Economic Analysis, National Data, Fixed Assets, Table 4.1.

Notes: The BEA's definition of intellectual property products is "Intangible fixed assets—whether purchased or produced for own use—that are used repeatedly, or continuously, in the processes of production for at least a year. In the NIPAs (National Income and Product Accounts), these products consist of software, of research and development, and of entertainment, literary, and artistic originals. (For practical reasons, the NIPAs include mineral exploration within its estimates of nonresidential structures, even though the output of mineral exploration can be considered to be an intellectual property product.)"

The BEA's data are consistent with the general consensus that intangible assets have been playing an increasing role in the economy.¹¹ In 1925, IPP accounted for 1% of the nonresidential corporate capital stock. Growth in IPP has followed a general upward trend, and in 2020, it accounted for 16% of the nonresidential corporate capital stock. This general upward trend in IPP

¹¹ Other estimates that tell a similar story include Carol A. Corrado and Charles Hulten, "How Do You Measure a 'Technological Revolution'?" *The American Economic Review: Papers and Proceedings of the One Hundred Twenty Second Annual Meeting of the American Economic Review*, vol. 100, no. 2 (May 2010), pp. 99-104; Carol Corrado and Janet X. Hao, "Brands as Productive Assets: Concepts, Measurement, and Global Trends," *WIPO Economic Research Working Papers*, November 2013; Carol Corrado et al., "Intangible Investment in the EU and US before and since the Great Recession," *Investment and Investment Finance in Europe 2016* (Luxembourg: Economics Department, European Investment Bank, 2016), pp. 73-101; Carol Corrado et al., "Advancements in Measuring Intangibles for European Economies," *Eurona*, no. 6 (2017); Eric Hazan et al., *Getting Tangible about Intangibles: The Future of Growth and Productivity?* McKinsey Global Institute, Discussion Paper, June 16, 2021, <https://www.mckinsey.com/business-functions/marketing-and-sales/our-insights/getting-tangible-about-intangibles-the-future-of-growth-and-productivity>.

was matched by an overall downward trend in the share of the capital stock attributable to corporate structures, from 75% in 1925 to 55% in 2020. The share attributable to equipment followed a humpback shape: it was relatively stable at around 24% through WWII, then increased until the mid-1990s (reaching 38% in 1996) before decreasing to 29% in 2020.

Basic Principles of International Income Taxation

Most international tax agreements and norms relate to income taxation. A starting point for understanding international taxation is determining which country has the first right to tax multinational corporate profits. The international and historical norm, embedded in tax treaties, has been that the first right to taxation belongs to the country in which a corporation's assets are located. More generally, the norm has been that in order for a country to have a right to tax part of a corporation's profits, the corporation must have a physical presence in the country (a permanent establishment), which is termed *nexus*. Some have challenged this norm with the growth in digital service providers and have argued that customer use of these services creates value, therefore giving the countries where customers are located a right to taxation. This issue is discussed later in the report—see “The Debate on Digitalized Companies and Value Creation.”

Another norm is that corporate income should not be subject to double taxation (i.e., two countries taxing the same income). Even if the first right to tax is with the country where a corporation's assets are held, the corporation's home country may also tax income earned abroad by its resident firms (through a subsidiary or a branch). Two general approaches exist to prevent double taxation. One extreme is for a country to simply forgo taxing any income that its resident firms earn abroad. This approach is called a *territorial system*. Another extreme is for a country to tax the income its resident firms earn abroad, but to also allow a credit for foreign taxes paid (i.e., a foreign tax credit). With a foreign tax credit, the home country will collect residual tax if the foreign countries' overall tax rate is lower and no tax if the foreign countries' tax rate is higher. This approach is called a *worldwide system*.

In practice, countries have some mix of territorial and worldwide taxation. Most countries have taxes to prevent firms from using their foreign subsidiaries to shift profits into low-tax countries. These are referred to as controlled foreign corporation (CFC) rules in general, and in the United States as Subpart F rules (named after the code section where the treatment is imposed). The United States also has a minimum tax on the income of foreign subsidiaries that is applied at a rate lower than the regular corporate tax and that allows for an exclusion for a return on tangible assets. This tax is called the global intangible low-taxed income (GILTI) tax, and the OECD/G20 has proposed a global minimum tax of a similar nature (Pillar 2). Both the GILTI tax and the Pillar 2 proposal are discussed later in this report—see “Profit Shifting.” Income earned through a branch operation (an operation that is not through a foreign-incorporated affiliate) is taxed at full rates.

The United States allows a foreign tax credit, but it is limited to U.S. taxes paid on an overall basis, within several “baskets.” The major baskets, to which limits are applied separately, are active branch income, passive income, other active income, and GILTI. This overall limitation on the foreign tax credit means that unused foreign taxes in high-tax countries that exceed the U.S. tax can be used to offset U.S. tax in low-tax countries (called cross-crediting). An alternative approach that is under consideration by Congress in H.R. 5376 would impose a per-country limit. With such a limit, the full U.S. tax would be collected in countries with no taxes.

Two important issues arise when determining the first right to tax and whether to adopt a territorial or worldwide tax system, and when imposing the limitation on foreign tax credits: (1) what rules will lead to a desirable allocation of investment; and (2) what rules will limit artificial

profit shifting, where firms and their subsidiaries locate profits in low-tax jurisdictions. These issues are discussed below.

Issues in the Taxation of Corporations in a Global Economy

The interconnected nature of the global economy creates several challenges in designing a corporate tax system, as taxes can affect economic activity. This section discusses three important issue areas: how international tax rules can affect the location of investment; profit shifting; and the debate on digitalized companies and value creation.

Location of Tangible Investment

International tax rules can alter the location of investment, which, in turn, can change the incidence of the overall U.S. corporate tax and affect economic efficiency. Tangible assets (such as buildings and equipment) are located in a specific place where they are used and are often difficult, if not impossible, to relocate. Intangible assets, in contrast, can be provided without additional costs to consumers around the world. The location of intangible assets can be easier to move from one country to another without compromising the asset's value. When considering how international tax rules affect the incidence of the corporate tax and economic efficiency, concern is largely focused on the location of tangible assets. The location of intangible assets is more important when considering how tax rules affect the location of profits. Profit shifting is discussed in the next section.

The incidence of the overall U.S. corporate tax refers to the extent to which the burden of corporate taxes reduces wages or reduces after-tax returns to saving. In a closed economy, the corporate tax burden generally falls on capital income.¹² In an open economy, the burden can also fall on wages if the corporate tax results in investment moving abroad. The shifting of investment abroad reduces the amount of capital available to U.S. workers, reducing their productivity, and therefore their wages. How the incidence of the corporate tax is split—between labor and capital—also determines the distributional (equity) effects of the corporate tax across incomes because the majority of capital income accrues to higher-income individuals.

Second, the tax treatment of foreign-source income affects economic efficiency. Economic efficiency measures the degree to which resources, in this case capital, are employed in their most productive use. Efficiency costs can arise if lower taxes abroad cause capital to be invested in low-tax countries where it is less productive. Taxes distort the allocation of capital by driving a wedge between the after-tax return (what investors care about) and the economic return (what matters for efficiency purposes).

¹² With a fixed capital stock and a fixed labor supply, a corporate tax causes capital to move to the noncorporate sector and the tax spreads out to profits on both corporate and noncorporate capital, but wages are largely unaffected. See Arnold Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, vol. 7, no. 2 (June 1962), pp. 215-240. The precise effects depend on the capital intensity of each sector, the ability to substitute capital and labor in each sector, and certain model assumptions, but there is a tendency for the burden to fall on capital. See Jane G. Gravelle and Laurence J. Kotlikoff, "The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good," *Journal of Political Economy*, vol. 27, iss. 4 (August 1989), pp. 749-780, for some illustrative calculations.

Studies of the degree to which corporate taxes fall on labor or capital seem to indicate that most of the burden falls on capital.¹³ This effect occurs in part because of economic constraints and preferences that limit international capital flows. The effect on efficiency is also small, in part because of these same limitations on capital flows and because tax rates of the large countries where most tangible investments occur are reasonably close together.¹⁴ Nevertheless, equalizing the tax rates on the return to domestic capital and foreign-located capital could improve efficiency and benefit U.S. labor. One option would be to reduce the tax on domestic corporate income, though this option may not be practical given federal revenue needs. The second option would be to increase the tax on foreign-source income.

Tax rates on foreign-source income could be increased in a number of ways within the current tax system. The current tax rules tax income earned abroad at a lower rate. The tax on global intangible low-taxed income, or GILTI, allows a deduction for 10% of tangible assets. This deduction is aimed at largely exempting the returns from foreign tangible investment from U.S. tax. Imposing a residual U.S. tax so that the rate on foreign-source income would at least match the rate applying to domestic income could potentially both reduce the burden of the corporate tax on labor and improve efficiency, because U.S. multinational corporations would not be influenced by tax considerations in their location choices. Such a change would require eliminating the deduction for tangible assets (so that tangible asset income is subject to the tax) and raising the effective tax rate on GILTI to the U.S. statutory rate. It would also require the imposition of the limit on the foreign tax credit to U.S. taxes due on a per-country basis, so that unused credits from high-tax countries do not offset tax in low-tax countries. For example, if the U.S. tax rate is 21% and Ireland's tax rate is 12.5%, these changes would impose a residual U.S. tax of 8.5%, which would equate the tax on domestic and foreign investment.

Some Members have introduced proposals to make such changes, including S. 20 (Klobuchar), S. 714 (Whitehouse), H.R. 1785 (Doggett), S. 991 (Sanders), and H.R. 2254 (Schakowsky). The Administration's budget proposal would set the GILTI rate at the current tax rate of 21% but also would raise the overall corporate tax rate to 28%, so some differences would remain. However, the elimination of the deduction for tangible assets would impose that 21% tax rate on the return to tangible investment.¹⁵ The House-passed Build Back Better proposal (H.R. 5386) would raise the GILTI rate to 15.015%; that proposal retains a reduced deduction of 5% for tangible assets. A similar proposal is in the Senate Finance Committee's draft legislation.¹⁶

Although economic theory indicates that the major concerns about international taxes are corporate tax incidence and efficiency, two other arguments frequently appear in the discussion of

¹³ See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle, pp. 18-35, for a review of the data.

¹⁴ See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle, p. 40, for a discussion. Other factors could reverse the capital flow effects; for example, if debt is more mobile than equity, tax subsidies for debt that favor U.S. investment with higher corporate tax rates could reverse the effects. Also, for companies earning excess returns, the portion of corporate taxes that falls on this income is born by stockholders. See also CRS Report R45186, *Issues in International Corporate Taxation: The 2017 Revision (P.L. 115-97)*, by Jane G. Gravelle and Donald J. Marples for a discussion of efficiency issues.

¹⁵ See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*, May 2021, <https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals> for a discussion of the budget proposals. See CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle for revenue estimates.

¹⁶ See CRS Report R46960, *Tax Provisions in the Build Back Better Act: Rules Committee Print 117-18*, coordinated by Molly F. Sherlock, for a summary of the proposal.

the tax treatment of foreign-source income. The first is a *competitiveness* argument.¹⁷ In economic analysis, however, *countries* engage in trade, not competition, and trade involves mutually beneficial exchange.¹⁸ When countries specialize in what they have a comparative advantage at producing and trade for what they have a comparative disadvantage at producing, they are able to produce more together than in isolation.¹⁹ Greater production leads to more product variety, lower consumer prices, and greater average incomes. *Companies* do compete against each other and foreign counterparts for customers, market share, investors, and the like. A company is competitive if it can produce at the same cost as, or a lower cost than, other firms.²⁰ But a country's firms cannot be competitive in all areas. Thus, while taxation of foreign-source income can affect the size of U.S. multinational corporations and the industries they operate in, a contraction in these industries will be accompanied by an expansion in other industries that will utilize labor resources.

The second argument that is sometimes used to support increased taxation of foreign investment is that by favoring foreign locations, a country is exporting jobs. Again, in economic analysis, given an existing labor force the economy will create jobs (although there are policy issues related to frictional or transitional unemployment that would occur in the absence of taxes). Jobs lost in the multinational industries will be replaced by jobs in other industries. The effect on labor from favoring foreign investment is on wages, not overall jobs.

Profit Shifting

International tax rules can also affect the location where profits are recognized. As discussed above, the historical norm has been that the first right to tax corporate profits belongs to the country in which a corporation's assets are located. Profit shifting focuses not on where investment takes place, but on the artificial location of profits in countries with low tax rates, thereby depriving countries like the United States of revenue. There are two major ways profits are shifted: (1) pricing of transactions between related firms (that is, where one firm has majority ownership of another firm), or *transfer pricing*, and (2) the location of debt. The most recent estimates are that 72% of profit shifting arises from transfer prices that deviate from arms-length prices (prices that would be charged to unrelated parties).²¹ This share may be higher now given low interest rates and the growth of intangible assets, where arms-length pricing is more difficult to determine.

¹⁷ For further discussion, see Jane G. Gravelle, "Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?" *Tax Law Review*, vol. 65, no. 3 (2012), pp. 323-348.

¹⁸ Although economists generally believe that trade is generally beneficial to an economy overall, it is also recognized that particular groups may be hurt in the short term as the economy shifts its specialization focus. Several policy options are available to Congress to assist those displaced by trade, including subsidies to assist affected industries, unemployment insurance, and retraining programs, among others. A key issue when contemplating potential policy options is how to effectively target assistance to those hurt by trade while not preventing the realization of the widespread benefits of trade.

¹⁹ Comparative advantage is not a technical or unfamiliar concept; it is a common, everyday occurrence. A lawyer may be able to do his or her paralegal employee's work more efficiently, but that activity is not the best use of his or her time. A lawyer has an absolute advantage in both law practice and paralegal work but a comparative advantage in practicing law.

²⁰ Cost includes the opportunity cost, which is the high-valued alternative a firm could pursue.

²¹ Jost H. Heckemeyer and Michael Overesch, *Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels*, Center for European Economic Research, Discussion Paper 13-045, 2013, <https://ftp.zew.de/pub/zew-docs/dp/dp13045.pdf>.

How Significant Is Profit Shifting?

The growth of intangible assets in large multinational firms created a strong interest among academics and policymakers in measuring the effects on profit shifting, and some estimates indicated that a sizable revenue loss occurred under law prior to the TCJA (before 2018), perhaps in the neighborhood of \$100 billion or more.²² One estimate indicated that almost all of the profits shifted are in the major tax havens (Bermuda, the Cayman Islands, Ireland, Luxembourg, Netherlands, Puerto Rico, Singapore, and Switzerland) and that GILTI, which was enacted in the TCJA, would have a small effect on profit shifting due to firms' ability to use taxes from high-tax countries to credit against income from the tax havens.²³ Early data comparisons following GILTI's enactment show continued disproportionately large profits in tax haven countries.²⁴ One estimate of the loss from profit shifting during the new regime enacted in 2017 indicated a loss of \$77 billion.²⁵ The cost of profit shifting was expected to decline due to the lower corporate tax rate, while the shift in international regimes from the taxation of dividends but not income retained abroad to the GILTI regime, which taxes intangible income at a lower rate, has uncertain effects.

Transfer Pricing

Transfer pricing relates to measuring the prices of sales between firms under common control and aims to impose the prices that would be charged to unrelated parties, called arms-length pricing. To illustrate how prices that are not arms-length result in profit shifting, consider a U.S. parent firm that sells a good or service to a related subsidiary in a low-tax country at a price below the market price it would receive if it directly exported the product to an unrelated customer. The underpricing on the sale reduces profits and taxes in the United States and increases the share of profits reported in the low-tax country. Additionally, the subsidiary in the low-tax country can sell the product or export it to the final customer at the full market price.

The most important transfer pricing issues are associated with the sale of the rights to an intangible asset by licensing the rights to a foreign firm and charging a royalty or selling the intangible asset (i.e., selling the rights to use the intangible asset for a specific geographic market). It has been common for large multinationals that have products with intangible returns embedded in them (e.g., smartphones or drugs) or who directly sell or otherwise use an intangible asset directly to serve the final user (such as a search engine, social media platform, or online

²² See Elke Asen, "What We Know: Reviewing the Academic Literature On Profit Shifting," *Tax Notes International*, May 24, 2021, pp. 1030-1043; Kimberly Clausing, "Profit Shifting before and after the Tax Cuts and Jobs Act," *National Tax Journal*, vol. 73, no. 4 (December 2020), pp. 1233-1266; Sebastian Beer, Ruud A. De Moois, and Li Liu, *International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots*, International Monetary Fund Working Paper No. 18/168, July 23, 2018, <https://www.imf.org/en/Publications/WP/Issues/2018/07/23/International-Corporate-Tax-Avoidance-A-Review-of-the-Channels-Effect-Size-and-Blind-Spots-45999>.

²³ Kimberly Clausing, "Profit Shifting before and after the Tax Cuts and Jobs Act," *National Tax Journal*, vol. 73, no. 4 (December 2020), pp. 1233-1266.

²⁴ See Joint Committee on Taxation, *U.S. International Tax Policy: Overview and Analysis*, JCX-16R-21, April 19, 2021, <https://www.jct.gov/CMSPages/GetFile.aspx?guid=aa66e305-74cc-40bc-acad-55bb3e6d5971>, which compared 2017 and 2018 tax data; and Testimony of Kimberly A. Clausing, Deputy Assistant Secretary, U.S. Department of the Treasury, Tax Analysis, Before the Senate Committee on Finance, March 21, 2021, <https://home.treasury.gov/news/press-releases/jy0079>, which compared data from 2000 through 2019 from the Commerce Department.

²⁵ See The Tax Justice Network, *The State of Tax Justice 2021*, November 2021, https://taxjustice.net/wp-content/uploads/2021/11/State_of_Tax_Justice_Report_2021_ENGLISH.pdf.

marketplace) to locate the rights to sell those products abroad in countries with low or no income taxes, which is the broad definition of a tax haven.²⁶

In a typical transfer pricing arrangement used to shift profits, the U.S. parent sets up a foreign subsidiary in a no-tax country, such as Bermuda or the Cayman Islands, and the subsidiary makes a “buy-in” payment for the rights to the intangible asset for sale abroad. As research and technological advance continues, the foreign subsidiary engages in cost-sharing: it pays for a share of the research costs in the United States in exchange for ongoing use of the updated technology. The buy-in price is for a unique good, and it may be difficult for tax authorities to determine an arms-length price because the cost-sharing arrangement for a successful firm earning larger than normal returns would not reflect the price that would be charged to an unrelated party. That is, cost-sharing does not attempt to determine an arms-length price, but rather typically requires cost-sharing payments proportional to expected benefits. By setting the buy-in price and the cost-sharing payments below arms-length prices, a firm can shift an intangible’s profits to a no-tax foreign country without significant additional tax on these payments in the United States.

These tax arrangements are aimed not only at shifting profits to countries without taxes, but also being able to carry out real activities (such as marketing) elsewhere since many no-tax countries are small and do not have a labor force to support real activity. These arrangements also need to avoid withholding taxes on royalties, which are common in many countries unless they are eliminated or reduced by treaties that are not normally extended to tax havens.²⁷ They are also facilitated by a U.S. tax provision called check-the-box (discussed below).

Debt

A second method of shifting profits to a low-tax country is to locate debt in a high-tax country because interest on debt is deducted from taxable income. A U.S. multinational firm may locate its debt largely in the United States or other high-tax countries, reducing profits through interest deductions, while its subsidiaries in low-tax countries have a larger share of the profit because they have no interest deductions. Loans may be made from a low-tax country to a related firm in a high-tax country, generating interest deductions and reducing taxable income in the high-tax country, while increasing profits in the low-tax country. This issue is of particular concern for U.S. subsidiaries of foreign parents, where the subsidiary borrows from the parent and where profit shifting is difficult to address through taxing foreign subsidiaries in the case of U.S. multinationals. This practice has also been seen in “inverted” U.S. firms that shift their

²⁶ Tax havens are sometimes broadly defined in this way, although other definitions are more narrow, focusing on countries that have a lack of information sharing or secrecy laws, or special rates for foreign companies. For purposes of considering corporate profit shifting, this broad definition is appropriate. See CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle for further discussion.

²⁷ Treaty arrangements often eliminate these taxes, although usually not with tax havens, so that profits need to be routed through a country that has such a treaty. One popular scheme, which has now been eliminated by the Irish government, was the “double Irish Dutch sandwich,” where profits owned by an active Irish subsidiary were routed through an intermediate parent in the Netherlands before being paid to a no-tax country. See Anup Srivastava, Hussein Warsame, and Luminita Enache, “Doubling Down on Double Sandwich Tax Schemes,” *California Management Review*, vol. 63, iss. 3 (Spring 2021), <https://cmr.berkeley.edu/2020/03/doubling-down/>. There is a current arrangement, nicknamed the “Green Jersey,” which allows purchases of intangible assets to generate deductions to offset profits. See Emma Clancy, “Apple, Ireland and the New Green Jersey Tax Avoidance Technique,” *Social Europe*, July 2018, <https://socialeurope.eu/apple-ireland-and-the-new-green-jersey-tax-avoidance-technique>.

headquarters to a foreign low-tax country. The U.S. firm becomes the subsidiary and borrows from the parent.²⁸

Rules to Address Profit Shifting

A number of rules, some traditional and some recently added, have been made to address profit shifting. Although some of these rules, such as GILTI, were enacted in 2017 to reduce profit shifting, early data show that a disproportionate share of foreign profits are located in tax havens, and that the share reported in tax havens is not much different from that under prior law.²⁹

Transfer Pricing Rules

Most countries follow a common set of transfer pricing rules (adopted by the OECD) that are aimed at setting prices at arms-length, although these methods are imperfect.³⁰ There are several methods allowed when arms-length prices cannot be observed for comparable transactions, including the profit-split method that permits cost-sharing arrangements. For example, if a subsidiary's profits are 25% of the overall expected profits from an investment in research, the subsidiary can be assigned those rights by contributing 25% of the cost. A company further developing an already popular technology (such as a cell phone) that is likely to earn large profits would be unlikely to agree to such an arrangement with an unrelated company since that arrangement would transfer above-normal profits to another firm.

Subpart F

Although most countries do not tax earnings of their firms' foreign subsidiaries, they also have anti-abuse rules to deal with easily shifted income. In the United States, these rules are referred to as Subpart F. Subpart F taxes certain passive income paid between related foreign subsidiaries at full U.S. rates and on a current basis. Examples of income subject to Subpart F taxation include interest and royalties, which can be used to reduce income of foreign subsidiaries in high-tax countries. Subpart F also taxes "base company income" where profits from sales of goods and services are in a country that is different from the producer and consumer.

Subpart F's effectiveness has been limited in a number of ways. For example, credits are allowed for foreign taxes on Subpart F income up to the amount of U.S. taxes due, but that limit is imposed on an *overall* basis instead of a *county-by-country* basis. This allows corporations to offset taxes due in a low-tax country by applying unused credits generated in a high-tax country in a tax planning technique known as *cross crediting*. Subpart F's effectiveness also has been undermined by a regulatory rule developed in the late 1990s called "check-the-box" and a temporary statutory provision that broadens the scope of check-the-box called the "look-through" rule.³¹ These rules allow subsidiaries to ignore related party transactions that would otherwise be

²⁸ See CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle for a discussion.

²⁹ See Joint Committee on Taxation, *U.S. International Tax Policy: Overview and Analysis*, JCX-16R-21, April 19, 2021, <https://www.jct.gov/CMSPages/GetFile.aspx?guid=aa66e305-74cc-40bc-acad-55bb3e6d5971>, which compared 2017 and 2018 tax data; and Testimony of Kimberly A. Clausen, Deputy Assistant Secretary, U.S. Department of the Treasury, Tax Analysis, Before the Senate Committee on Finance, March 21, 2021, <https://home.treasury.gov/news/press-releases/jy0079>, which compared data from 2000 through 2019 from the Commerce Department.

³⁰ For a discussion of the various methods, see Elizabeth Hughes and Wendy Nicholls, "The Different Methods of TP: Pros and Cons," *Tax Journal*, September 28, 2020, <https://www.taxjournal.com/articles/different-methods-tp-pros-and-cons>.

³¹ For further discussion, see CRS In Focus IF11392, *H.R. 1865 and the Look-Through Treatment of Payments Between*

taxed under Subpart F. The House-passed H.R. 5376 and the Senate Finance Committee draft contain provisions to strengthen Subpart F, including imposing a per-country limit on the foreign tax credit.

GILTI

The global intangible low-taxed income (GILTI) tax was adopted in 2017 and, as discussed above, is aimed at imposing a minimum tax on intangible income earned by foreign subsidiaries. (Under prior law, foreign-source income outside of Subpart F income was taxed when paid as a dividend; the 2017 act eliminated the tax on dividends.)³² The tax rate is half the U.S. tax rate, rising to 62.5% of the rate after 2025. GILTI allows an exemption for a deemed return of 10% of tangible assets. This exemption is designed to approximate the return to tangible investment, thereby roughly imposing a zero tax on those earnings and creating an incentive to invest in low-tax jurisdictions. A credit is allowed for 80% of the foreign taxes on GILTI, limited to U.S. taxes paid, but this limit is imposed on an overall basis so that foreign taxes that exceed the limit in high-tax countries can eliminate U.S. taxes in low-tax countries. Proposals discussed in the section on “Location of Tangible Investment” to increase the tax rate on GILTI to the U.S. statutory rate and impose a per-country limitation would eliminate or reduce the tax incentive for U.S. companies to shift profits into tax havens.

The Base Erosion and Anti-Abuse Tax (BEAT)

BEAT imposes a lower alternative tax (currently 10%, scheduled to rise to 12.5% after 2025) on a base that adds certain payments of U.S. firms to related foreign corporations to the regular corporate income tax base. It does not allow for foreign tax credits (or other credits except for selected ones on a temporary basis) and does not include any payments for inventory. BEAT was enacted in 2017 partly to address profit shifting by U.S. subsidiaries of foreign parents who cannot be reached with GILTI. The Administration proposes to replace the current BEAT with a “stopping harmful inversions and ending low-tax developments” (SHIELD) provision, which would not provide an alternative tax but would disallow deductions for all payments to related firms in tax havens. The Administration argued that this proposal would be more effective and better targeted than BEAT.³³ H.R. 5376 would retain BEAT, but increase the tax rate to 12.5% in 2023, 15% in 2024, and 18% in 2025 and after. A similar provision is in the Senate Finance Committee draft bill. It would make BEAT less likely to apply, however, by allowing tax credits, but would also add certain payments for inventory to the base. This provision would raise revenue after the rate increases took place.

Limits on Interest Deductions

Current tax law limits interest deductions to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA). This measure of earnings has now changed to a narrower measure,

Related Controlled Foreign Corporations, by Jane G. Gravelle. For a history of how check-the-box developed, see Jeff Gerth, “Corporations Couldn’t Wait to ‘Check the Box’ on Huge Tax Break,” *ProPublica*, September 26, 2011, <https://www.propublica.org/article/corporations-couldnt-wait-to-check-the-box-on-huge-tax-break>.

³² A companion provision providing a deduction for foreign-derived intangible income (FDII) was added to provide a domestic benefit that would offset the GILTI tax deduction benefit in part. It is set at the same rate at which GILTI, with its 80% foreign tax credit, would apply. However, foreign-source intangible income in tax havens is still taxed at a lower rate under this formula and can be shielded by credits from foreign taxes in high-tax countries. Proposals to revise GILTI would in some cases repeal FDII and in others reduce its value.

³³ U.S. Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals*, May 2021, <https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf>.

earnings before interest and taxes (EBIT), in 2022, causing a more restrictive limit. This restriction on interest does not specifically target multinationals, but it addresses a gap in BEAT, which may not be an effective measure to address profit shifting via debt because it has a low rate and only some firms pay it. Proposals have been included in some of the bills noted above, the Administration's budget proposals, and the Build Back Better Act (both H.R. 5376 and the Senate Finance Committee draft) to allocate interest of multinationals to the United States according to the U.S. share of total earnings, thus directly focusing on multinationals.

Stricter Anti-Inversion Rules

Inversions refer to a U.S. company moving its headquarters abroad, which can facilitate profit shifting since the new company and its foreign subsidiaries are not subject to U.S. taxes (such as GILTI and Subpart F), and the new parent company can lend to its U.S. subsidiary.³⁴ Current law contains anti-inversion measures, including treating new firms that are 80% owned by former U.S. shareholders as U.S. firms. Firms that are 60% to 80% owned are subject to tax on the transfer of assets. Proposals have been included in some of the bills cited above, as well as in the Senate Finance Committee draft of the Build Back Better Act, to further restrict inversions. The Administration proposal and some of the bills cited above would treat as U.S. corporations firms that are more than 50% owned by former U.S. shareholders. The Senate Finance Committee draft of the Build Back Better Act would change the 80% and 60% amounts to 65% and 50%, respectively.

Multilateral Proposals

The OECD and the G20 have been developing a proposal called the global anti-base erosion (GLoBE) tax, under which all countries would impose a global minimum tax similar to GILTI.³⁵ This tax is Pillar 2 of a two-pillar proposal (Pillar 1 is discussed in the next section). On June 5, 2021, finance ministers of the G7 countries, including the United States, agreed to a global minimum tax of 15%.³⁶ On November 4, 2021, the OECD reported that 137 countries have agreed to this plan.³⁷ The G20 endorsed the plan on July 10, 2021.³⁸

³⁴ See CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle for a discussion.

³⁵ The OECD has 38 members; for a list of the 37 members before Costa Rica joined in May 2021, see <https://www.oecd.org/about/document/ratification-oecd-convention.htm>. The G20 is composed of 19 countries and the European Union. The 19 countries are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, and the United States. The OECD was formed in 1960 when countries came together to work out mutual economic agreements, and it remains the principal advisory body for multinational tax standardization. The G20 was founded in 1999 to address international financial stability. The G20 represents large nations in terms of output; not all members of the G20 are members of the OECD. Pillars 1 and 2 are following up on an inclusive framework to address base erosion and profit shifting that involved 137 countries.

³⁶ "G7 Finance Ministers and Central Bank Governors Communiqué," June 5, 2021, posted on U.S. Department of Treasury website, <https://home.treasury.gov/news/press-releases/jy0215>. The G7 are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. All of the G7 countries are members of the OECD and the G20. The G7 was formed in the mid-1970s.

³⁷ OECD, "Members of the OECD/G20 Inclusive Framework on BEPS joining the October 2021 Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy as of 4 November 2021," <https://www.oecd.org/tax/beps/oecd-g20-inclusive-framework-members-joining-statement-on-two-pillar-solution-to-address-tax-challenges-arising-from-digitalisation-october-2021.pdf>.

³⁸ G20 Italia 2021, Italian G20 Presidency, "Third Finance Ministers, and Central Bank Governors Meeting, Communiqué," July 9-10, 2021, <https://www.g20.org/wp-content/uploads/2021/07/Communique-Third-G20-FMBCBG-meeting-9-10-July-2021.pdf>.

The Debate on Value Creation and Digitalized Companies

The growth of companies that provide digital services (such as search engines, online marketplaces, and sites for social networking) has led to an argument that departs from international norms on the taxation of profits—namely that users create value. As discussed above, the traditional international norm is that the first right to taxation of profits belongs to the country where the asset is held. In the case of intangible assets, that asset may be held where it is created or the rights to profits may be sold to a firm in another country (usually a related firm) and that country then has the first right to tax the profits. International concerns about profit shifting are focused on allocating the profits to countries in which the asset was created, used with the payment of an arms-length royalty, or purchased at an arms-length price.

International rules require a permanent establishment for a country to have any right of taxation (also called *nexus*); once there is a permanent establishment (such as a manufacturing facility or sales operation), there is a determination of what share of profits is taxed. This allocation is straightforward in theory, but becomes complex in practice when these transactions are made within the firm (such as a branch manufacturing operation) or with related firms (such as foreign-incorporated subsidiaries) where arms-length royalties or prices are difficult to enforce. The following example illustrates how traditional international norms are used to determine which country has the first right of taxation. This illustration uses the example of a drug formula that is relatively straightforward. Consider a U.S. firm that develops a drug and wishes to serve customers in a foreign market. The firm has several options that affect taxing rights. It can manufacture the drug in the United States and export it, it can manufacture the drug abroad through a branch operation, it can license the rights to a foreign firm and charge a royalty, or it can sell the rights themselves to a foreign firm.

The price of the drug reflects the return to two investments: the investment in the research that created the drug formula and the investment in manufacturing facilities that make the drug. If the drug is made in the United States, all of the profits (sales price minus costs) are U.S. sourced and taxed in the United States. If the drug is manufactured abroad through a branch operation, the first right to tax the profit from the return on manufacturing is in the foreign country, while the first right to tax the return on the research is in the United States. If the rights to the formula are licensed to a foreign firm, the U.S. firm receives a royalty that is taxed in the United States, and the foreign country has the right to include the profits with a deduction for the royalties. If the rights are sold to a foreign firm, the sales price is taxed in the United States and the foreign country has the right to tax profits net of the acquisition price. In all of these cases, if prices were set to reflect an arms-length transaction, the return should always be sourced to where the capital investment value was made. The first right to tax the profit from the drug formula creation (whether directly, through royalties, or through sale of the rights) is in the United States, where the research costs were incurred.³⁹ Once the drug formula is sold, the country where this asset is held has the right of taxation. The location of customers has no effect on taxing rights.

The same reasoning applies to digital services. For example, a firm can invest in a search algorithm and also have servers that provide the physical hardware. The profits associated with the algorithm are much like the drug formula. An algorithm developed in the United States should

³⁹ Although sale of an intangible asset (i.e., selling the rights to produce or sell the product in a certain geographic area while accruing the sales as revenues) transfers the location of future taxation, arms-length pricing would compensate the firm in the country that originally created the assets with the expected present value of the future earnings, and the firm in the country that purchased the asset would pay the present value of their future earnings. In practice, these prices are not likely to be arms-length, especially as the United States allows cost-sharing arrangements where firms finance part of the research in the United States in exchange for the rights to ongoing technological development with an implicit price that, for a successful firm, is unlikely to be offered to an unrelated party.

be taxed by the United States via export, direct operation through a branch, royalties, or sale of the rights to the algorithm. The return on the servers and other physical assets should be taxed in the country where they are located. Under this reasoning, the location of users has no effect on taxing rights. With the advent of companies that provide digital services that are often free to consumers (such as search engines, online marketplaces, and sites for social networking), some countries have argued that the country where the users reside should have a right to tax some of the profits generated in there because the users create value—a view that is not consistent with taxation based on where the asset is held. They also argue that these companies escape taxes on some of their profits by locating assets in tax havens. Several countries have imposed digital services taxes, although generally in the form of excise taxes rather than income taxes (such as taxes on advertising revenues, digital sales of goods and services, or sales of data), while proposed changes in the taxation of profits are being discussed.⁴⁰

Pillar 1 of the OECD/G20 two-pillar proposal would allocate some rights to market countries (where users are located) to tax profits of digitalized firms (and these countries would eliminate their digital services excise taxes).⁴¹ In 2020, then-Secretary of the Treasury Steven Mnuchin signaled the U.S. position that negotiations over Pillar 1 were at an impasse.⁴² On June 5, 2021, finance ministers of the G7 countries, including the United States, agreed to allow market countries a share of 20% of the residual profits (defined as profits after a 10% margin for marketing and distribution services) of large multinational companies.⁴³ This agreement does not have force and is only viewed as a first step. The proposal would allocate the residual share based on revenues (such as sales of advertising) and the location of the user for an array of digital services and split 50:50 between purchaser and seller for online markets.

This agreement fundamentally departs from the traditional allocation rule for income taxes by assigning a share to the location of the user (or in the case of online market intermediaries, the seller and the customer) rather than basing taxation on where the asset is held. As noted above, in

⁴⁰ See CRS Report R45532, *Digital Services Taxes (DSTs): Policy and Economic Analysis*, by Sean Lowry for a further discussion. IRS proposed regulations would clarify that the foreign tax credit would not be available for these digital taxes formulated outside the framework on international norms even if they were formulated as income taxes, as the regulations included a requirement for jurisdictional nexus. See Internal Revenue Service, REG-101657-20, September 29, 2020, at <https://www.irs.gov/pub/irs-drop/reg-101657-20.pdf>. The UK has a diverted profits tax (sometimes called the Google tax because it was enacted in a dispute with Google, although Google has reached an agreement with the UK tax authorities to use a different transfer pricing mechanism). See Alvarez and Marsal, “The Impact of the U.K. Diverted Profits Tax,” September 14, 2017, <https://www.alvarezandmarsal.com/insights/impact-uk-diverted-profits-tax>. The United States also determined to impose tariffs against seven countries that imposed digital excise taxes: France, Austria, India, Italy, Spain, Turkey, and the UK, although these tariffs were temporarily suspended until November 29, 2021. On November 18, the United States Trade Representative (USTR) announced suspension of these proposed tariffs given the negotiations regarding Pillar 1 of the OECD/G20 proposal. See Office of the United States Trade Representative, “Termination of Actions in the Section 301 Digital Services Tax Investigations of Austria, France, Italy, Spain, and the United Kingdom and Further Monitoring,” 86 *Federal Register* 64590, November 18, 2021, <https://www.federalregister.gov/documents/2021/11/18/2021-25199/termination-of-actions-in-the-section-301-digital-services-tax-investigations-of-austria-france>.

⁴¹ The OECD/G20 blueprint provides a positive list of the businesses covered: “sale or other alienation of user data; online search engines; social media platforms; online intermediation platforms; digital content services; online gaming; standardized online teaching services; and cloud computing services” and online marketplaces. See OECD/G20, *Tax Challenges Arising from Digitalisation—Report on Pillar One Blueprint*, 2020, <https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en.htm>.

⁴² See letter from Secretary of the Treasury Stephen T. Mnuchin to the finance ministers of France, Spain, and Italy and the Chancellor of the Exchequer, United Kingdom, June 12, 2020, <https://assets.kpmg/content/dam/kpmg/us/pdf/2020/06/tmf-mnuchin-oecd-jun19-2020.PDF>.

⁴³ G7 Finance Ministers and Central Bank Governors Communiqué, June 5, 2021, posted on U.S. Department of the Treasury website, <https://home.treasury.gov/news/press-releases/jy0215>.

the case of a search engine, the profits are largely a return on the search algorithms, which are properly allocated to the holder of the rights under traditional rules.

The argument frequently is made that customers or users create value for the firm by providing data that can be used to target advertising or be sold. This reasoning is not consistent with the economic concept of who earns the profit. In the normal direct sale of ordinary goods or services, there are customers who pay a price for the product, workers and intermediate inputs that are paid by the firm, and investments made to produce the product. The difference between revenues and expenses is the profit earned by the investment in assets (such as research or equipment and buildings used to manufacture and distribute the product). The investors are giving up resources in order to earn a future return. Customers have value, of course, and without them, there would be no sales and no investment, but they pay for a product in exchange for its value to them.

The provision of digital services is no different in concept. For example, with a search engine, a firm hires employees (such as programmers) and other resources and pays them to create algorithms and set up a website. The firm's investors give up resources in order to earn profits in the future. The firm could charge the users a subscription to use the website, which would be a straightforward sale of a service to a customer. However, in many cases, a website can be used without charge, but the firm makes its revenues by selling advertisements that users must view. In terms of monetary exchange, the customers are the advertisers who purchase the right to advertising. The users implicitly pay by having to look at ads, which provide the basis for the firm's ability to earn a profit by selling them to the advertising customers. This approach is not a novel one confined to digital companies: magazines and newspapers commonly finance part of their cost by advertising, and radio and television, until the advent of subscription services, provided free viewing and relied on advertising. This analogy does not change when a digital service finances itself by selling data collected from users. The investors spend resources to create digital services from which they expect future profits in the form of data sales, their customers are the purchasers of data, and users exchange access to their data for the right to use the website. In both cases, the firm's investors are giving up resources today to earn a profit in the future.

Although the Pillar 1 proposal does not conform to the traditional framework, it serves the purpose, if agreement is reached, of heading off the type of unilateral action that has developed with digital services taxes. From the viewpoint of the United States, which has large multinational digital firms, the Pillar 1 arrangement is likely costly. The excise taxes that would be eliminated are borne largely by the customers, that is, an advertising tax decreases the net price from sales and will lead to higher prices to advertisers, which will in turn be reflected in higher product prices to customers, who are largely in the country imposing the excise tax. Were countries to unilaterally impose taxes that are tied to profits without an agreement, under proposed IRS regulations,⁴⁴ U.S. multinationals would not receive a U.S. foreign tax credit and the burden would fall largely on the profits of these firms. With a multinational agreement such as Pillar 1, the U.S. foreign tax credit would presumably be allowed for these taxes (unless Congress intervenes),⁴⁵ which reduces revenues for the U.S. government, and the burden would fall on U.S. persons in general. On one hand, Treasury Secretary Janet Yellen has indicated that the proposal will be largely revenue neutral.⁴⁶ On the other hand, one estimate has set the revenue loss to the United States at \$10.3 billion annually.⁴⁷ At the same time, the United States has an interest in maintaining harmonious relationships with the rest of the world, which may justify the loss of revenues. The acceptance of Pillar 1 has also been tied to establishing a global minimum tax under Pillar 2 and discouraging the so-called race-to-the-bottom as countries lower tax rates to attract capital.

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⁴⁴ Internal Revenue Service, REG-101657-20, September 29, 2020, <https://www.irs.gov/pub/irs-drop/reg-101657-20.pdf>.

⁴⁵ The proposed regulations indicate that the regulations would be reconsidered if the United States entered into an agreement.

⁴⁶ Letter to Senator Mike Crapo, June 4, 2021, https://mnetax.com/wp-content/uploads/2021/06/Yellen_letter_to_Crapo_on_OECD_tax_negotiations920-1.pdf.

⁴⁷ Robert Goulder, “The Cost of Change: Pillar 1 Reduced to the Back of a Napkin,” *Tax Notes International*, reporting on estimates by Dan Neidle. Goulder cautions that these estimates should be considered “ballpark” and would depend on the specific design of the plan, as well as whether the United States modifies GILTI to conform to Pillar 2 and whether it allows a foreign tax credit.

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