Tax Foundation Comments on the Wyden, Warner, Brown Discussion Draft

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Introduction

Tax Foundation welcomes the opportunity to offer comments on the Wyden, Warner, Brown discussion draft on international taxation. Tax Foundation is a nonprofit think tank based in Washington, D.C., and our mission is to improve lives through tax policies that lead to greater economic growth and opportunity. We use the four principles of simplicity, neutrality, transparency, and stability when evaluating tax policies.

The Wyden, Brown, Warner discussion draft revisits many of the provisions put into law in 2017. The 2017 reforms in many ways brought the U.S. tax system more in line with those of other developed countries. In the areas where it departed from those systems, this new plan would exacerbate those differences.

The differences between the way the U.S. taxes the foreign income of multinationals and the way that other countries do results in an uneven playing field in foreign markets, to the disadvantage of American firms and workers.

U.S. companies succeed and maintain their success by developing innovative products and services that reach customers around the world. However, when U.S. policies create tax or regulatory penalties that are not faced by foreign competitors, those competitors have opportunities to gain market share and out-compete U.S. multinationals.

When U.S. companies are out-competed abroad due to U.S. policy burdens, that can have a ripple effect throughout the U.S. economy on the workers and supply chains that support the global business of local U.S. companies. According to the Bureau of Economic Analysis (BEA), in 2018, U.S. multinationals contributed 41.5 percent of private business capital expenditures and employed 28.6 million people in the U.S. They constitute an even larger share of high value-added activity, engaging in 74.2 percent of business research and development in the U.S. and earning 76.2 percent of all corporate income.

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Policy Analysis

While incomplete, the draft legislation from Senators Wyden, Brown, and Warner envisions significant changes to Global Intangible Low-Taxed Income (GILTI), Foreign Derived Intangible Income (FDII), and the Base Erosion and Anti-Abuse Tax (BEAT). Overall, the draft has the potential to address certain defects with the GILTI regime, but also has the potential to exacerbate certain uncompetitive features. The following is a list of our detailed concerns.

1. **Moves the U.S. back toward a worldwide system.** The 2017 tax reform moved the U.S. away from a purely worldwide tax system to one with territorial elements, particularly the dividends received deduction. While the tax rates are unclear, this plan would move the U.S. back toward a worldwide tax system, capturing a larger share of the foreign earnings of U.S. companies. This approach would take the U.S. backwards away from the longstanding trend of countries adopting territorial systems.

2. **The current structure of GILTI differs from international norms. Policymakers should not tighten GILTI if other countries don't adopt similar rules.** The current rules for GILTI are a departure from international norms and are more burdensome than those found in similar cross-border tax systems. While other countries are considering adopting rules modeled after GILTI in the form of a global minimum tax, U.S. lawmakers should be cautious of tightening the screws on this policy (as the draft legislation would do) while other countries have yet to adopt something like GILTI.

3. **Repealing QBAI departs from the approach other countries are exploring and transforms GILTI from a tax on mobile income to a broader tax on foreign activity.** The repeal of the deduction for Qualified Business Asset Investment (QBAI) for the calculation of the per-country minimum tax departs from the approach outlined in the recent statement signed by more than 130 countries (including the United States) on a global minimum tax. Removing QBAI would result in a heavier tax burden on the foreign earnings of U.S. companies than what other countries are considering. Repealing QBAI would also turn what was meant to be an anti-avoidance mechanism focused on mobile income bases into a tax that applies regardless of whether a company has an economic reason to be located outside the U.S. Many companies have factories and large economic footprints outside the U.S. not for tax avoidance reasons, but often to be close to their customers or to utilize well-established local supply chains in foreign jurisdictions. Removing QBAI will increase the tax burden on U.S. companies that need to be operating in foreign markets for economic reasons.

4. **The proposal repeals R&D and stewardship expense allocation and should also repeal interest expense allocation.** While the draft legislation appropriately addresses foreign tax credit expense allocation issues for research & development (R&D) and stewardship expenses, the work is incomplete. Expense allocation turns the U.S. minimum tax into a surtax on foreign earnings. While policymakers may be concerned about companies using debt to shift profits outside the U.S., the current thin capitalization rule (163(j)) is a better tool to address debt shifting than requiring interest expense to be allocated when calculating foreign tax credits.

5. **Timing adjustments are especially important.** Timing adjustments for the per-country minimum tax are going to be critical to avoid distortive outcomes for businesses. Foreign tax credits and net operating losses should be allowed to be carried forward so that companies do not face volatility and artificially high effective tax rates on their foreign earnings. While this is a problem even with current GILTI rules, moving to a per-country calculation would exacerbate the volatility that taxpayers will face without appropriate timing adjustments. Providing loss carryforwards would mitigate that volatility and allow taxpayers to be taxed on foreign profits averaged over the business cycle.

6. **Foreign tax credit haircuts cause problematic double taxation.** The proposal allows for the possibility of fully eliminating the haircut on foreign tax credits in existing law. The current haircut results in double taxation of foreign income of U.S. companies, and fully removing it would be sound policy. If the foreign tax haircut is not eliminated and is extended to Subpart F and foreign branch income, then that double taxation will also be extended to a larger swath of foreign income.

7. **Changing FDII fundamentally alters incentives for the location of intangible assets, and this will increase profit shifting.** The proposal contemplates changing the calculation of FDII from relying on the income from intangible assets to being calculated on a basis that includes R&D costs and worker training costs. The removal of the IP tax benefit will change the game for companies that have brought IP back into the U.S. tax base in recent years and will likely reduce the revenue raised from that mobile income tax base in the future.

8. **Policymakers should be careful about hiking rates too much.** While the proposal does not specify the rates at which foreign earnings will be taxed, lawmakers should consider the possible negative impacts on U.S. labor markets and U.S. investment that result from a heavy tax burden on foreign earnings.

As mentioned above, the approach outlined in the draft legislation could create disadvantages for U.S. multinationals when they are competing for market share against foreign-owned companies. While the tax rates are left undefined, the per-country calculations for foreign earnings and tax liability to the U.S. government will increase the compliance and administrative costs of U.S. cross-border tax rules. It is therefore critical that U.S. lawmakers attend to the need for appropriate timing adjustments, foreign tax credit offsets, and the potential revenue implications of removing an incentive to keep mobile income sources within the U.S. tax base.

Revenue Analysis

The Wyden-Warner-Brown proposal would reshape how the U.S. taxes multinationals, but it leaves unspecified critical parameters, particularly tax rates. The following analysis focuses on a basic version of the structure of their proposal, with minimal changes to tax rates.

The proposal would equalize the GILTI minimum rate (in the absence of foreign taxes) with the FDII rate, although this rate is left ambiguous. In the basic version modeled below, we assume both these rates are set at 13.125 percent (the FDII rate pre-2026, and the GILTI minimum rate beginning in 2026). It would also require that foreign taxes on GILTI, subpart F income, and foreign branch income all face the same haircut, although this haircut rate is only described as being between zero and 20 percent. For the basic version of their proposal, we model the 20 percent GILTI haircut as extended to taxes on subpart F and foreign branch income.

The proposal would switch to country-by-country calculations for GILTI, although it would include a mandatory high-tax exemption at the GILTI rate after application of the haircut on foreign taxes. It would also require a mandatory high-tax exemption on subpart F income, at the statutory corporate income tax rate after application of the haircut on foreign taxes.

As mentioned above, it would repeal the QBAI exemption for tangible assets from the GILTI calculation. It would repeal expense allocation for R&D and stewardship expenses.

Finally, the proposal would switch the FDII base calculation from deduction eligible income (DEI) less 10 percent of tangible assets to some percentages of R&D and worker training expenses, unless these expenses exceed DEI. In our modeling of the proposal, we include 100 percent of R&D and training expenses in this calculation.

Table 1 presents the effects on federal corporate income tax liabilities of these changes. By design, equalizing the GILTI minimum rate and the FDII rate at 13.125 percent raises revenue in the first four years when this is only an increase in the GILTI rate and loses revenue beginning in 2026 when this is only a decrease in the FDII rate. Extending the 20 percent foreign tax haircuts from GILTI to taxes on subpart F and foreign branch income raises $14.4 billion over the 10-year budget window. Switching the GILTI calculations to country-by-country and imposing mandatory high-tax exemptions for GILTI and subpart F raise $23.9 billion over 10 years; while the switch to country-by-country calculations raises revenue, the mandatory high-tax exemption for GILTI loses revenue because it reduces the burden of expense allocation. The high-tax exemptions substantially reduce the revenue raised from country-by-country calculations, but they shift the U.S.'s foreign taxes closer to the top-up system envisioned by the OECD's Pillar 2 proposal.

TABLE 1.

Effects of the Basic Version of the Proposal on Federal CIT Liabilities of U.S. MNEs

Change in federal corporate income tax liabilities of U.S. MNEs from Wyden-Warner-Brown proposal, billions of dollars

Provisions	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	Total
Equalize GILTI & FDII deduction rates	6.3	7.7	8.3	8.9	-3.0	-3.6	-3.7	-3.9	-4.0	-4.1	8.8
20% haircuts for subpart F and branch FTCs	0.6	1.0	1.2	1.4	1.5	1.6	1.7	1.8	1.8	1.9	14.4
Country-by-country GILTI, with high-tax exemption	1.5	1.8	2.0	2.2	2.3	2.5	2.6	2.8	2.9	3.1	23.9
Repeal QBAI exemption	0.8	1.0	1.1	1.1	1.2	1.2	1.3	1.3	1.3	1.4	11.6
Repeal R&D expense allocation	-2.8	-3.0	-3.2	-3.4	-3.5	-3.6	-3.7	-3.7	-3.8	-3.8	-34.5
Changes to FDII calculation	4.1	2.7	3.1	3.4	3.6	3.7	3.8	3.9	4.1	4.2	36.5
Total	10.5	11.3	12.5	13.5	2.0	1.8	2.0	2.2	2.4	2.7	60.8

Notes: The table presents the change in federal corporate income tax liabilities of U.S. multinationals, in billions of dollars, for each set of provisions. This basic version uses 37.5 percent deduction rates for GILTI and FDII, a GILTI high-tax exemption rate of 16.4 percent, a subpart F high-tax exemption rate of 26.25 percent, and 100 percent inclusion of R&D and worker training expenses in the new FDII calculations. All estimates use a semi-elasticity of 0.8 with respect to the average tax rate differential between the U.S. industry parent company and the controlled foreign corporations owned by the parent.

Source: Tax Foundation's Multinational Tax Model.

Repealing the QBAI exemption only raises $11.6 billion in this scenario. While this would raise significant revenue on its own, this is much less important with a high-tax exemption. Because larger countries with highly productive workers tend to have more tangible investment, and to choose higher tax rates relative to countries that choose to be tax havens, the mandatory high-tax exemption also substantially reduces the importance of the QBAI exemption.

Repealing expense allocation for R&D loses $34.5 billion. Although the proposal would repeal stewardship expense allocation, we do not have the data to model this; thus, the true revenue effect of the proposal (in total) is smaller than the estimated effect.

The changes to the FDII calculation would transform FDII from a tax rate reduction for high profits attributable to intangible assets (which are also easier to shift across borders) to a super-deduction on R&D and worker training expenses. Even including 100 percent of R&D and training expenses in this calculation, the new version of FDII (Foreign-Derived Innovation Income) provides smaller deductions than the current version of FDII. Although the proposal's changes to GILTI increase residual U.S. taxes on income in controlled foreign corporations, eliminating FDII's incentives to book income from intangible assets in the U.S. results in a net increase in profit shifting under the basic version of the proposal.

The results above pertain only to how the Wyden-Warner-Brown proposal would reshape how the U.S. taxes its multinationals, but most of the revenue from a final version of the proposal would come from changes to the corporate tax rate, to the minimum rate on GILTI and rate on FDII, and to the haircut rates on taxes on GILTI, subpart F, and foreign branch income. Table 2 considers how alternative rates and haircuts would affect the revenue from the proposal.

TABLE 2.

Effects of Alternative Versions of the Proposal on Federal CIT Liabilities of U.S. MNEs

10-year change in federal corporate income tax liabilities of U.S. MNEs from Wyden-Warner-Brown proposal, billions of dollars

Tax rate combinations		FTC haircuts	
CIT rate	GILTI/FDII	0%	20%
21%	13.13%	-0.2	60.8
21%	15%	87.9	155.3
25%	15%	419.5	493.8
25%	18%	576.5	647.6
28%	15%	661.0	739.7
28%	18%	822.3	898.6
28%	21%	977.7	1063.4

Notes: The table presents the change in federal corporate income tax liabilities of U.S. multinationals, in billions of dollars, for 2022–2031. Each version uses the basic structure from Table 1, with alternative corporate tax rates, effective GILTI and FDII rates, and haircut rates on taxes on GILTI, subpart F, and foreign branch income. The result from the basic version is bolded. All estimates use a semi-elasticity of 0.8 with respect to the average tax rate differential between the U.S. industry parent company and the controlled foreign corporations owned by the parent.

Source: Tax Foundation's Multinational Tax Model.

The basic version from Table 1 raised $60.8 billion over a decade. If this were instead implemented without the foreign tax haircuts, it would be essentially revenue-neutral, losing only $0.2 billion over 10 years. Using 15 percent FDII/GILTI minimum rates would raise $87.9 billion without the haircuts and $155.3 billion with the haircuts. Table 2 also presents the revenue effects using different combinations of 25 or 28 percent corporate income tax rates and 15, 18, and 21 percent FDII/GILTI minimum rates. At the extreme, a 28 percent corporate tax rate combined with 21 percent FDII/GILTI minimum rates and haircuts would raise $1.06 trillion over 10 years.

Conclusion

As the revenue analysis indicates, the proposed restructuring of the GILTI and FDII regimes makes several changes to the tax base that are largely offsetting, leaving virtually all the revenue potential to be determined by the tax rates on GILTI and FDII and the haircuts on foreign tax credits. Lawmakers should carefully weigh the trade-offs between higher tax revenues and competitiveness, noting that no other developed country currently has a GILTI regime or anything remotely approximating it. And while the OECD Pillar 2 negotiations aim to level the playing field via a global minimum tax, our analysis indicates that substantially increasing the GILTI tax burden would go beyond what is required by that standard.[1]

1 See Cody Kallen, "Options for Reforming the Taxation of U.S. Multinationals," Tax Foundation, Aug. 12, 2021, https://www.taxfoundation.org/us-multinational-tax-reform-options-gilti/; and Cody Kallen, "Expense Allocation: A Hidden Tax on Domestic Activities and Foreign Profits," Tax Foundation, Aug. 26, 2021, https://www.taxfoundation.org/expense-allocation-rules-hidden-tax-foreign-profits/.