The Tax Cuts and Jobs Act 2017

U.S. Corporate Tax Reform

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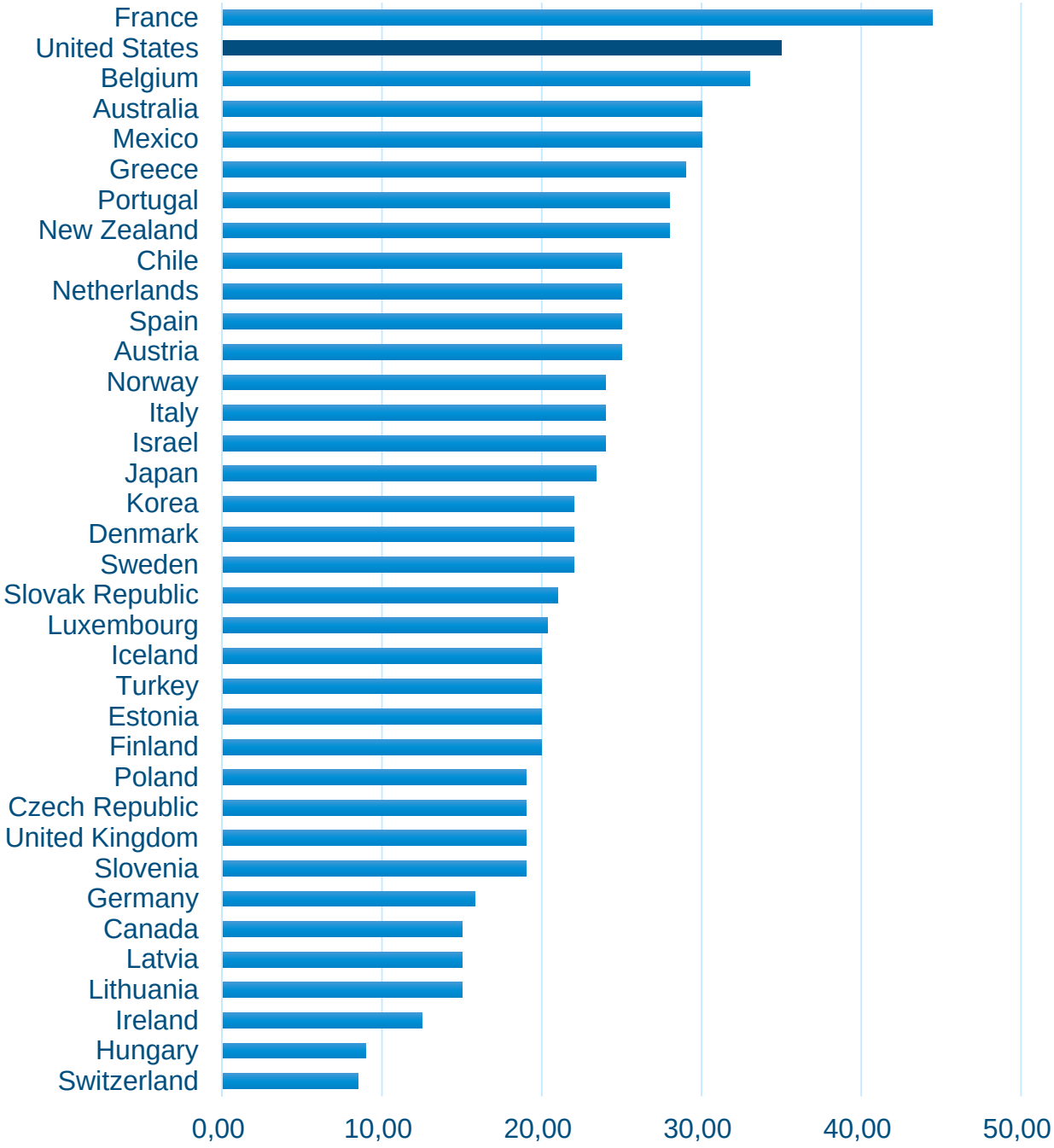
Problems With U.S. Corporate Tax Rate

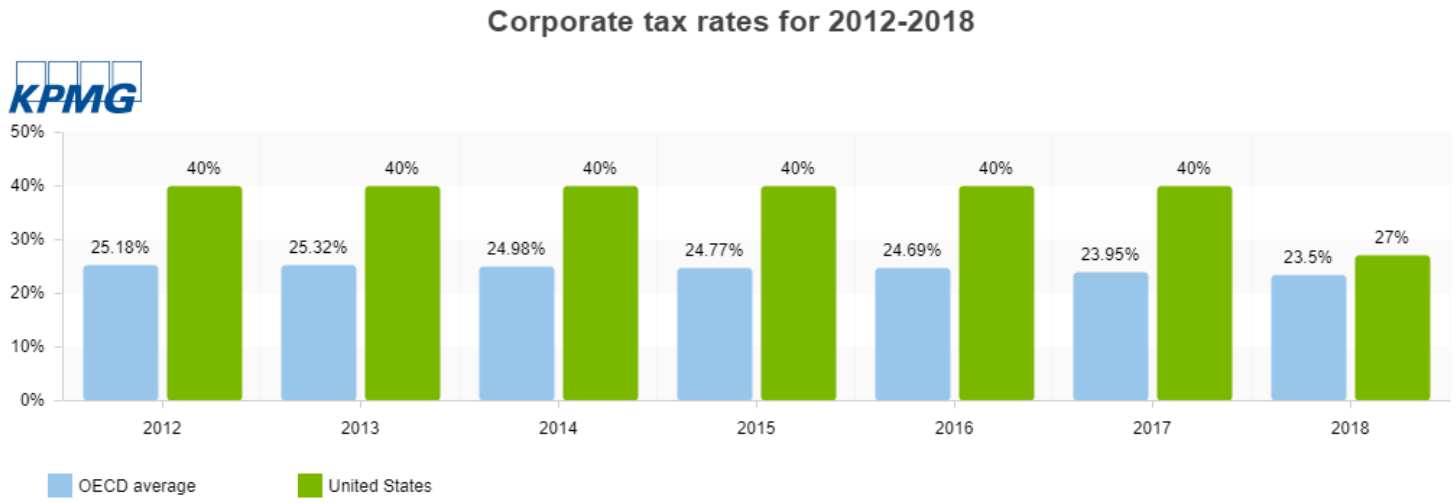
- Prior to the Tax Cuts and Jobs Act
  - The U.S. had one of the highest statutory corporate tax rates in the OECD
  - The third and fourth highest effective average corporate tax rate and marginal corporate tax rate, respectively
- A March 2017 report by the Congressional Budget office compared statutory tax rates across the G20 for the year 2012
  - At 39.1% when including state taxes, the U.S. had the highest statutory rate in the G-20
- What about effective average and marginal tax rates?
  - Account for total taxes paid as a share of income after deductions and credits
  - Our average corporate tax rate was 29%, the third highest in the G-20.
  - The effective marginal tax rate, which captures taxes on the marginal unit of investment, was at 19%, the fourth highest in the G-20.

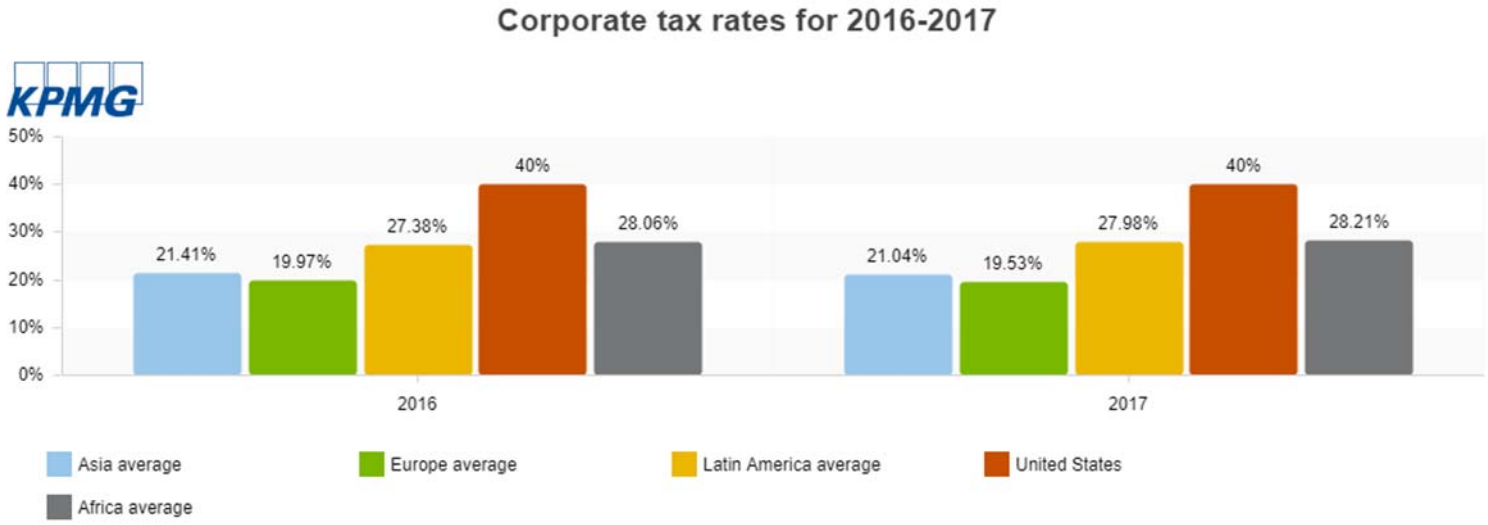
Statutory Corporate Income Tax Rate



Source:
https://stats.oecd.org/ , 2017

Top Statutory Corporate Tax Rates

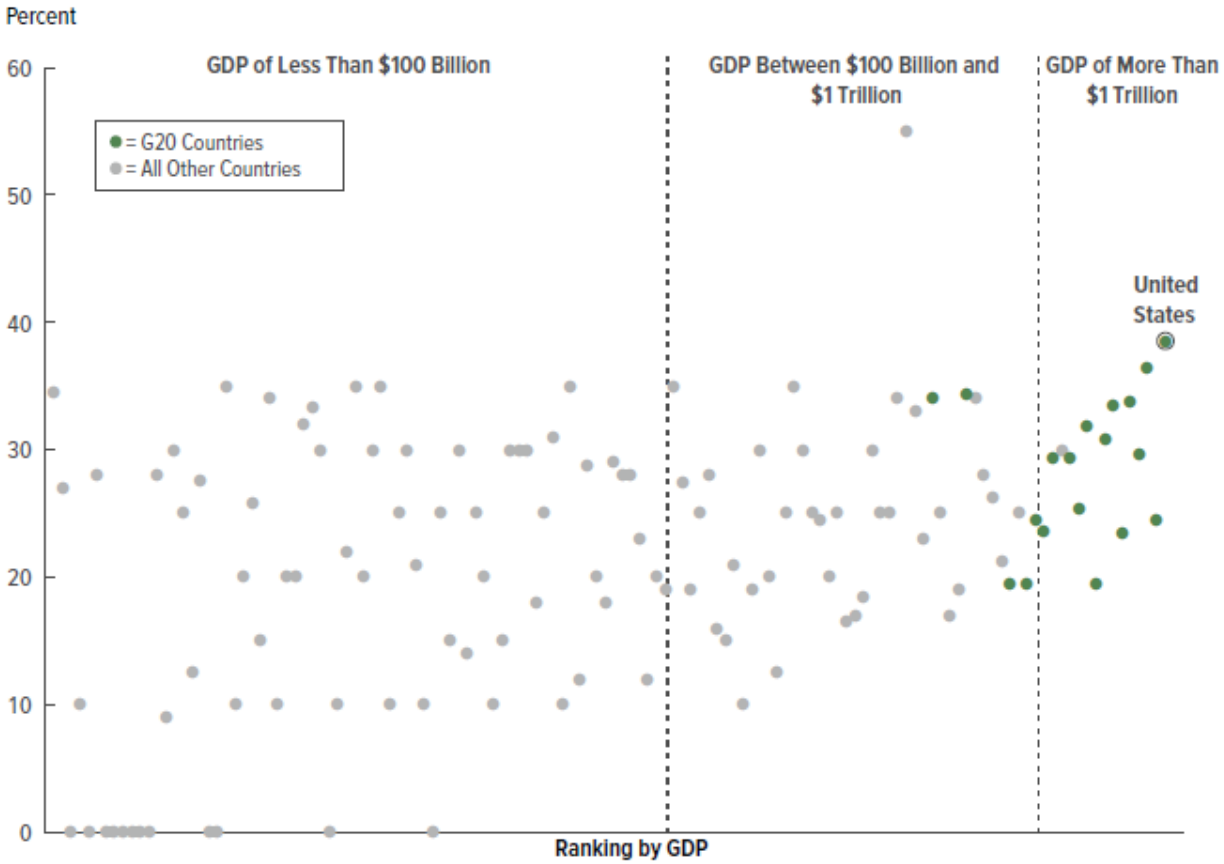




Corporate Tax Rates, 2012 (CBO)

Exhibit 2.

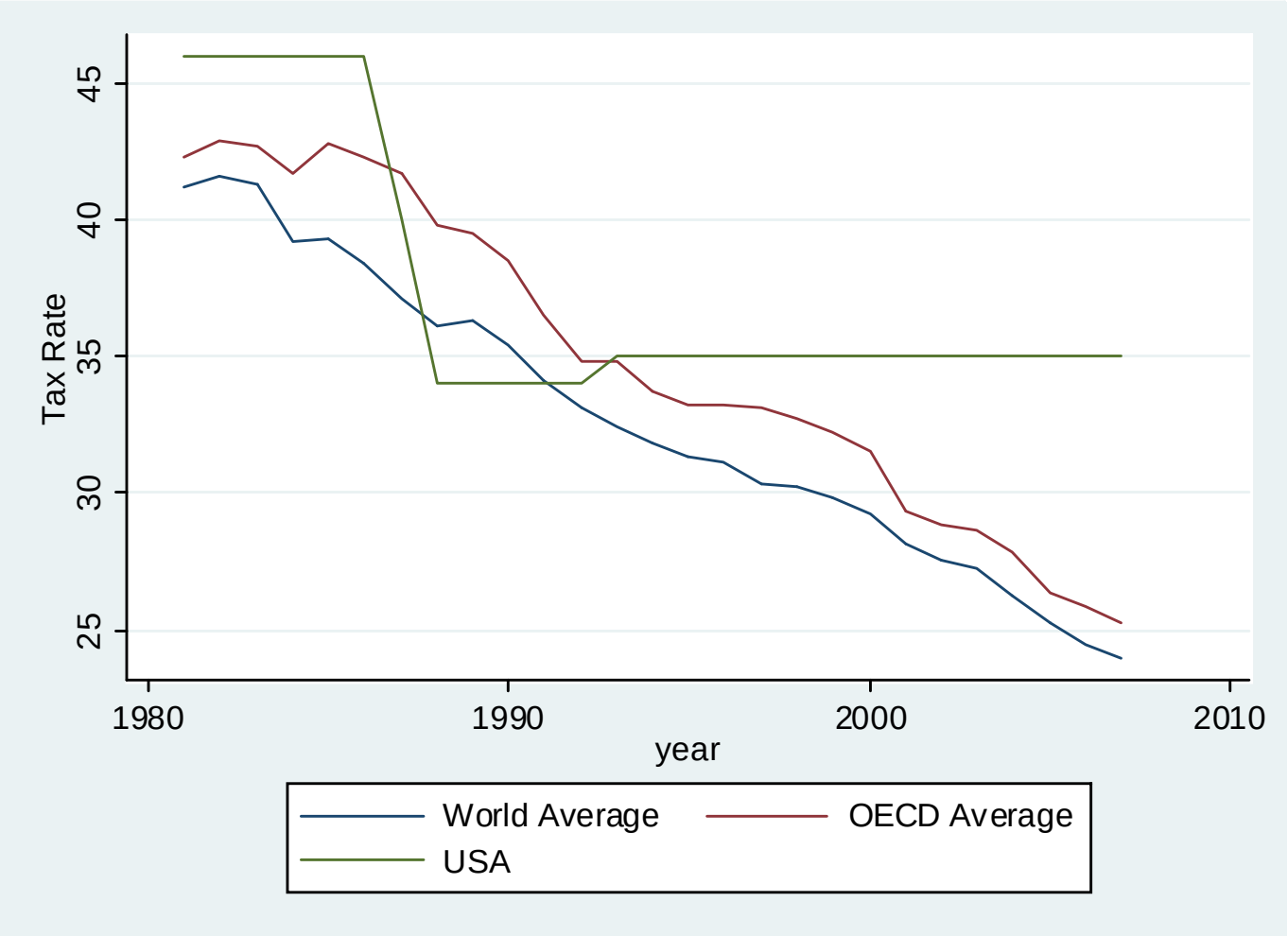
Top Statutory Corporate Income Tax Rates in Selected Countries, Arrayed by GDP, 2012



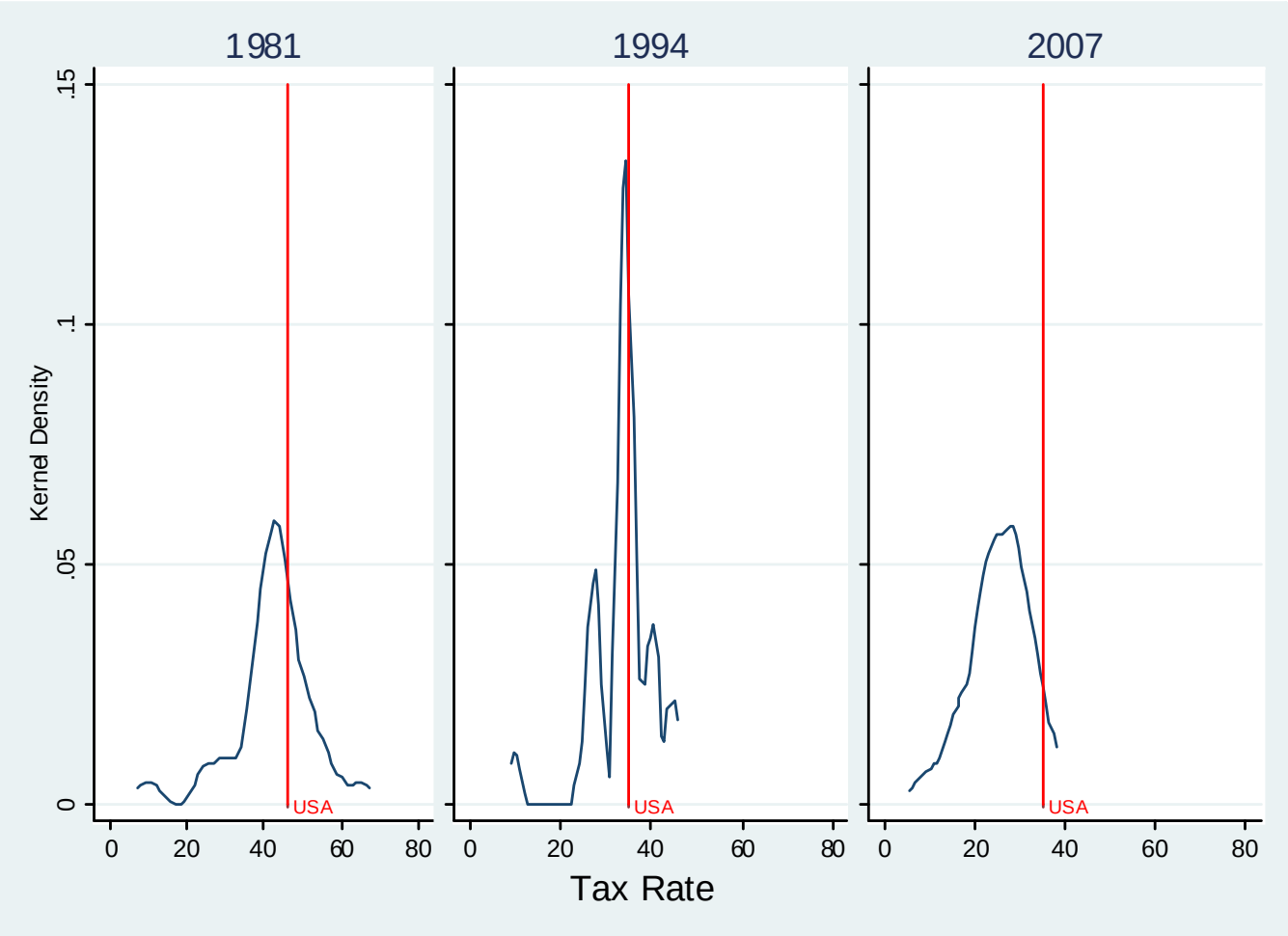
Source: Congressional Budget Office, using data from KPMG International and the Organisation for Economic Co-operation and Development.

GDP = gross domestic product; G20 = Group of 20.

Top Marginal Corporate Tax Rate – Central Government: AEI Tax Database



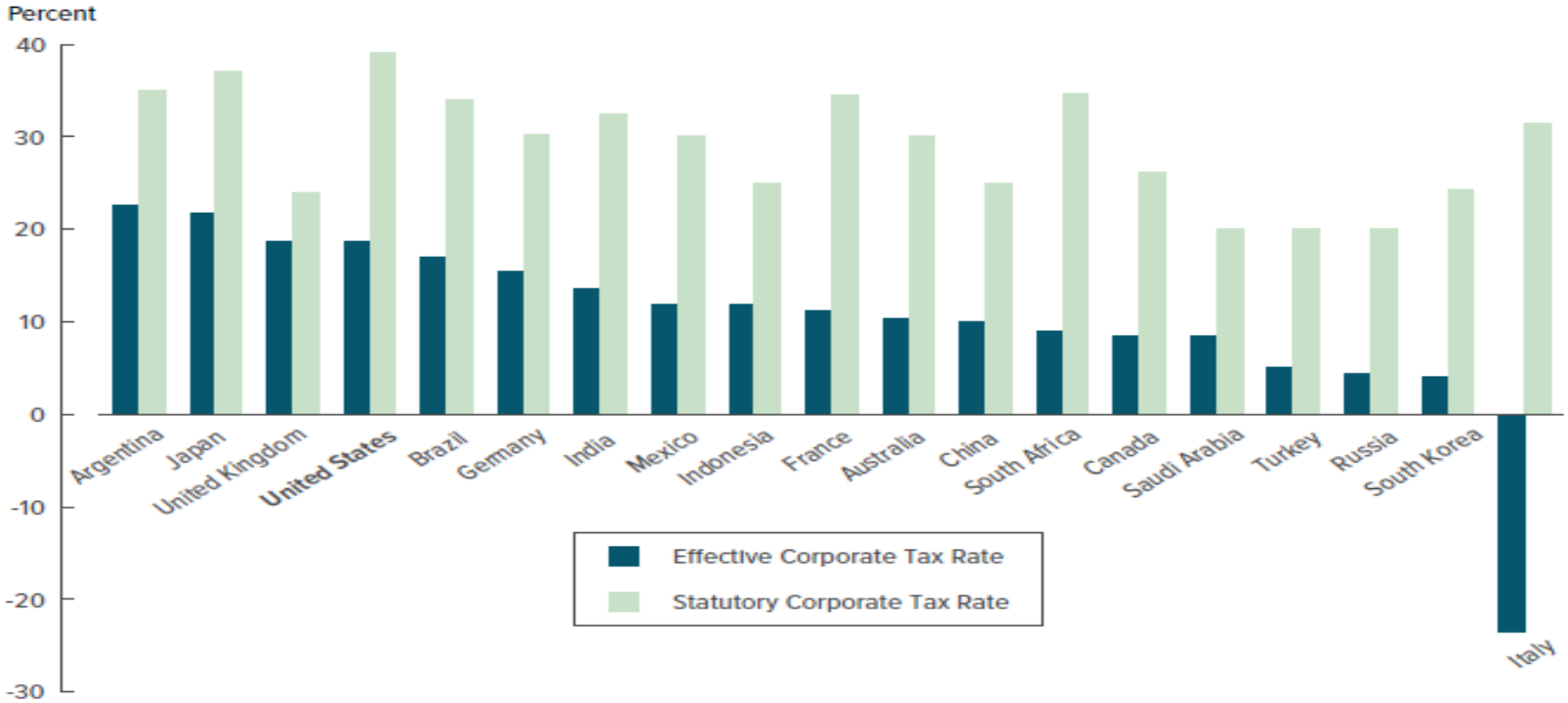
Distribution of Top Marginal Corporate Tax Rate in OECD: AEI Tax Database



Effective Average Corporate Tax Rates (EATR) (CBO, 2012)

Exhibit 7.

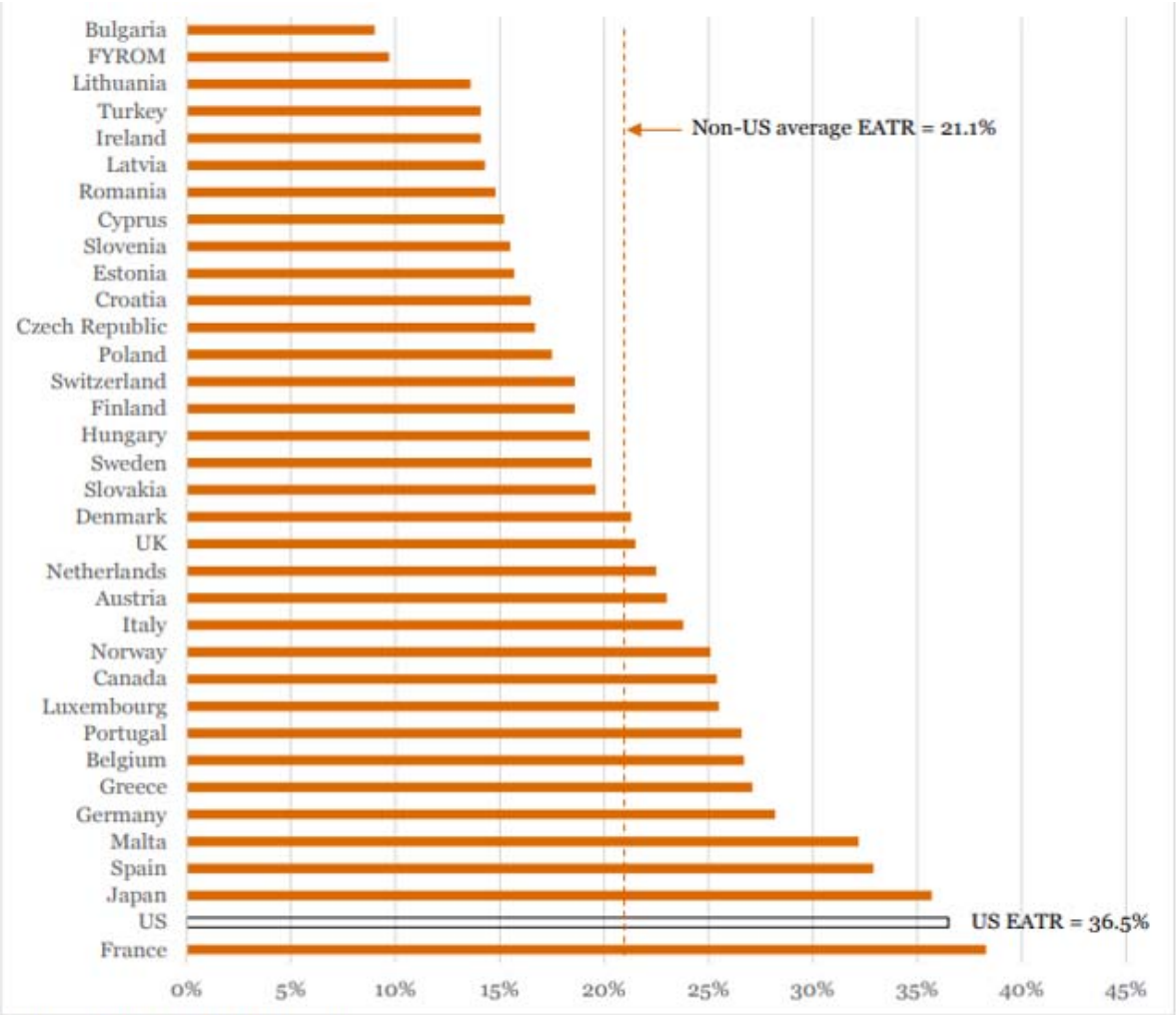
Effective Corporate Tax Rates and Top Statutory Corporate Income Tax Rates in G20 Countries, Inclusive of All Types of Assets and Financing Sources, 2012



Source: Congressional Budget Office, using data from KPMG International, the Organisation for Economic Co-operation and Development, and the Oxford University Centre for Business Taxation.

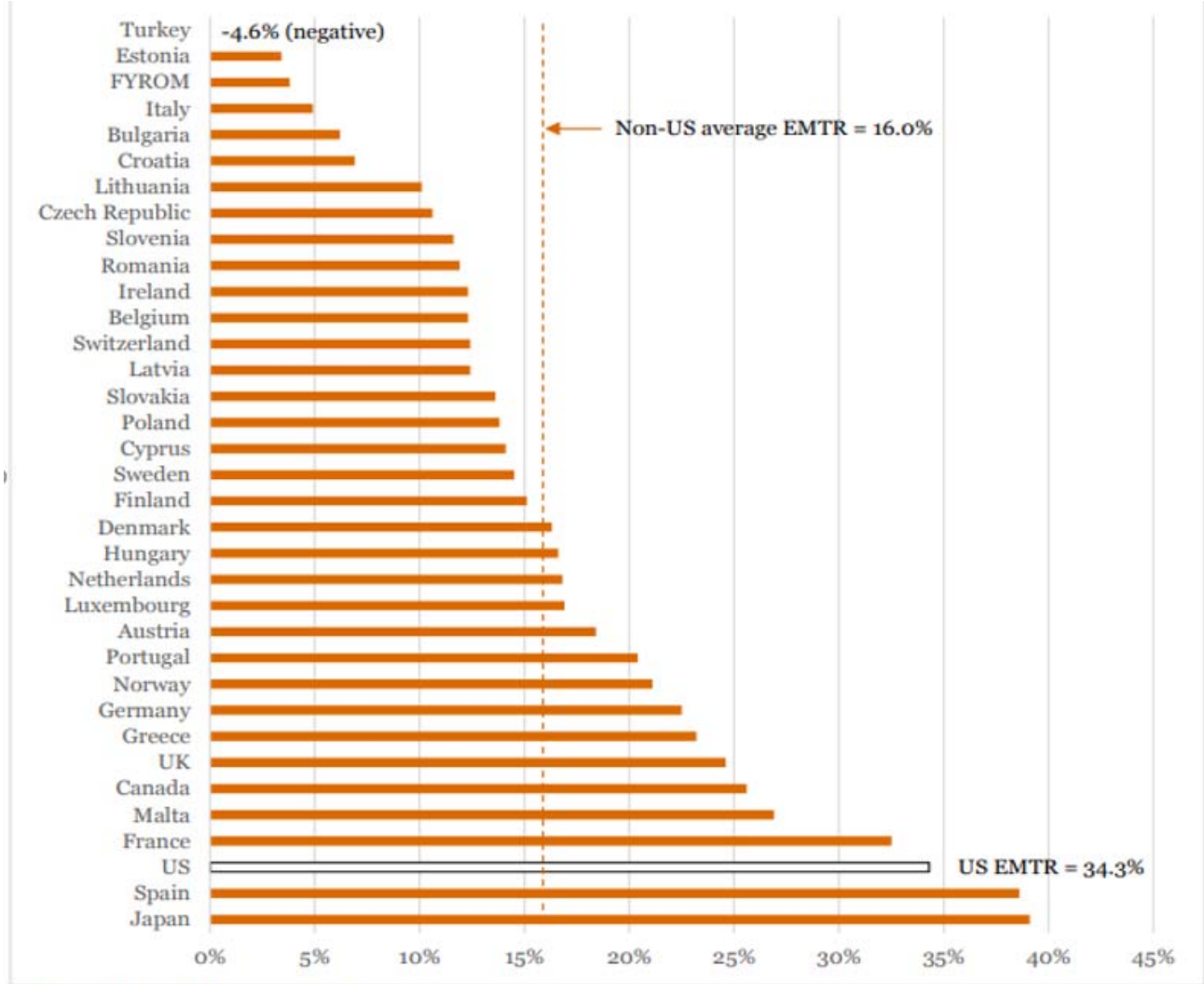
G20 = Group of 20.

Comparison of Effective Average Tax Rates, 2015



Source: European Commission.

Comparison of Effective Marginal Tax Rates, 2015



Source: European Commission.

International Taxation Rules

- Worldwide taxation vs territorial
  - A corporation based in the U.S. owes U.S. taxes on all of its income, regardless of where in the world it earns its income.
  - Foreign tax credits are allowed against taxes paid overseas
  - Taxes have to match or be greater than the U.S. tax liability
- Deferral: taxes paid only when money is repatriated to the U.S. parent as dividends
  - Incentive to keep profits overseas

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Economic Impacts of High Tax Rates and International Provisions

- Effects on Investment
- Effects on Workers
- Base Erosion and Profit Shifting
- Inversions
- Lock-Out of Corporate Earnings
  - Nearly $2.5 trillion are locked out due to repatriation taxes
- Loss of revenues
  - The CBO estimated that corporate tax revenues for the U.S. would decline from 2.3% of GDP in 2016 to 1.8% of GDP in 2025

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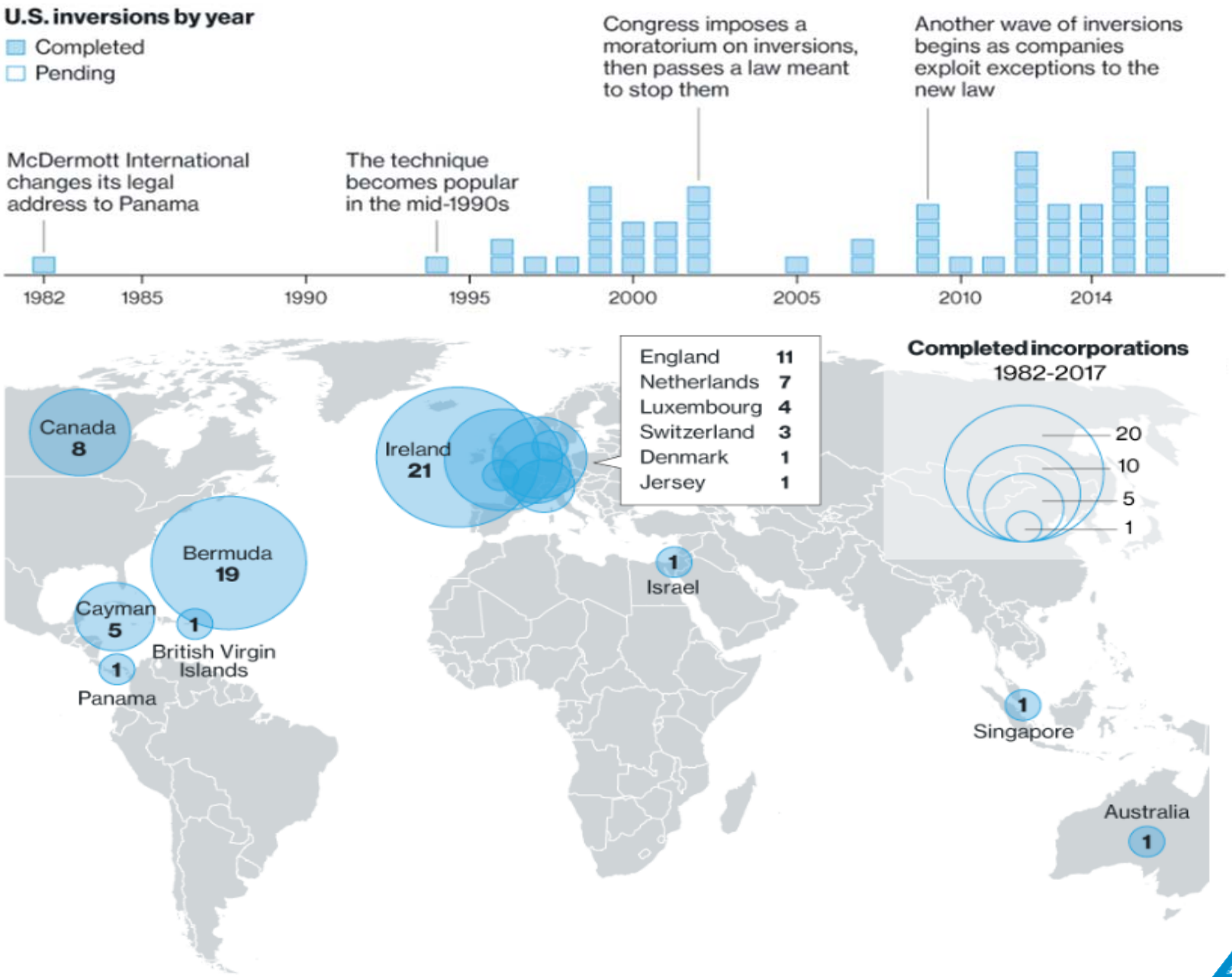
High Tax Rates Deter Investment

- Cross-sectional studies such as Grubert and Mutti (1991) and Hines and Rice (1994) estimate the effect of national tax rates on the distribution of aggregate American-owned property, plant and equipment in 1982. They report a negative elasticity with respect to local tax rates.
- The empirical literature discussed in Hassett and Hubbard (2002), has generally found that effective marginal tax rates significantly impact capital formation.
- Cummins, Hassett and Hubbard (1994) have documented the negative correlation between effective marginal corporate tax rates and investment across a large panel of countries.
- Devereux and Griffith (1998) conclude that the effective average tax rate plays an important role in the choice of investment location within Europe.

Tax Inversions

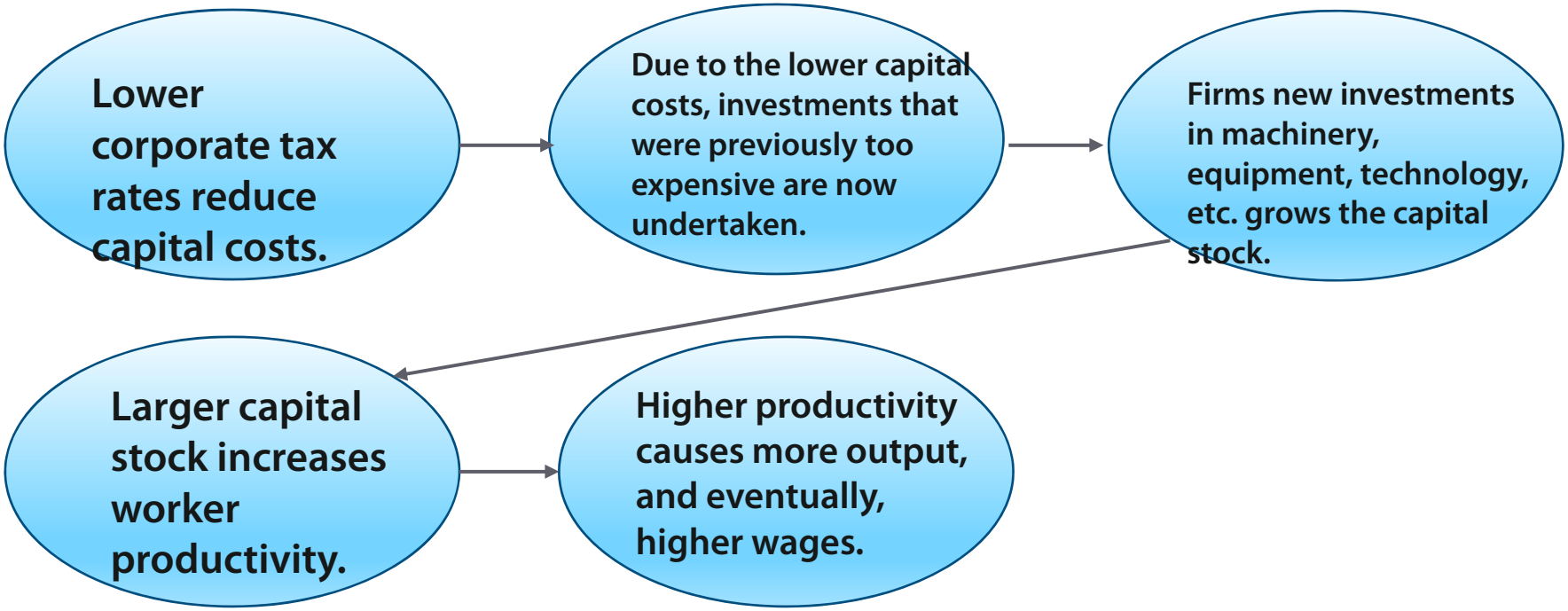
- A tax inversion occurs when a corporation purchases or merges with a foreign corporation, then subsequently declares the new resulting corporation to be domiciled in the foreign country that has a lower corporate tax rate than the U.S.
- To change its legal domicile, the company does not need to relocate its physical headquarters or change any of its business activities. It is merely a paperwork change after the merger.
- 51 US companies have reincorporated in low tax countries since 1982, including 20 since 2012


U.S. inversions by year
Completed
Pending
McDermott International changes its legal address to Panama
The technique becomes popular in the mid-1990s
Congress imposes a moratorium on inversions, then passes a law meant to stop them
Another wave of inversions begins as companies exploit exceptions to the new law
1982
1985
1990
1995
2000
2005
2010
2014
Completed incorporations
1982-2017
20
10
5
1
England 11
Netherlands 7
Luxembourg 4
Switzerland 3
Denmark 1
Jersey 1
Canada 8
Ireland 21
Bermuda 19
Cayman 5
British Virgin Islands 1
Panama 1
Israel 1
Singapore 1
Australia 1

Effect on Workers: Who Bears the Tax?

- Incidence of corporate income tax is a fundamental question in public economics.
  - Auerbach (2006)
- Statutory Incidence: Tax levied on the earnings of capital in the corporate sector.
  - Borne by shareholders, workers and consumers
  - Economic burden shifted forward as higher prices to consumers, lower returns to shareholders and lower wages to workers

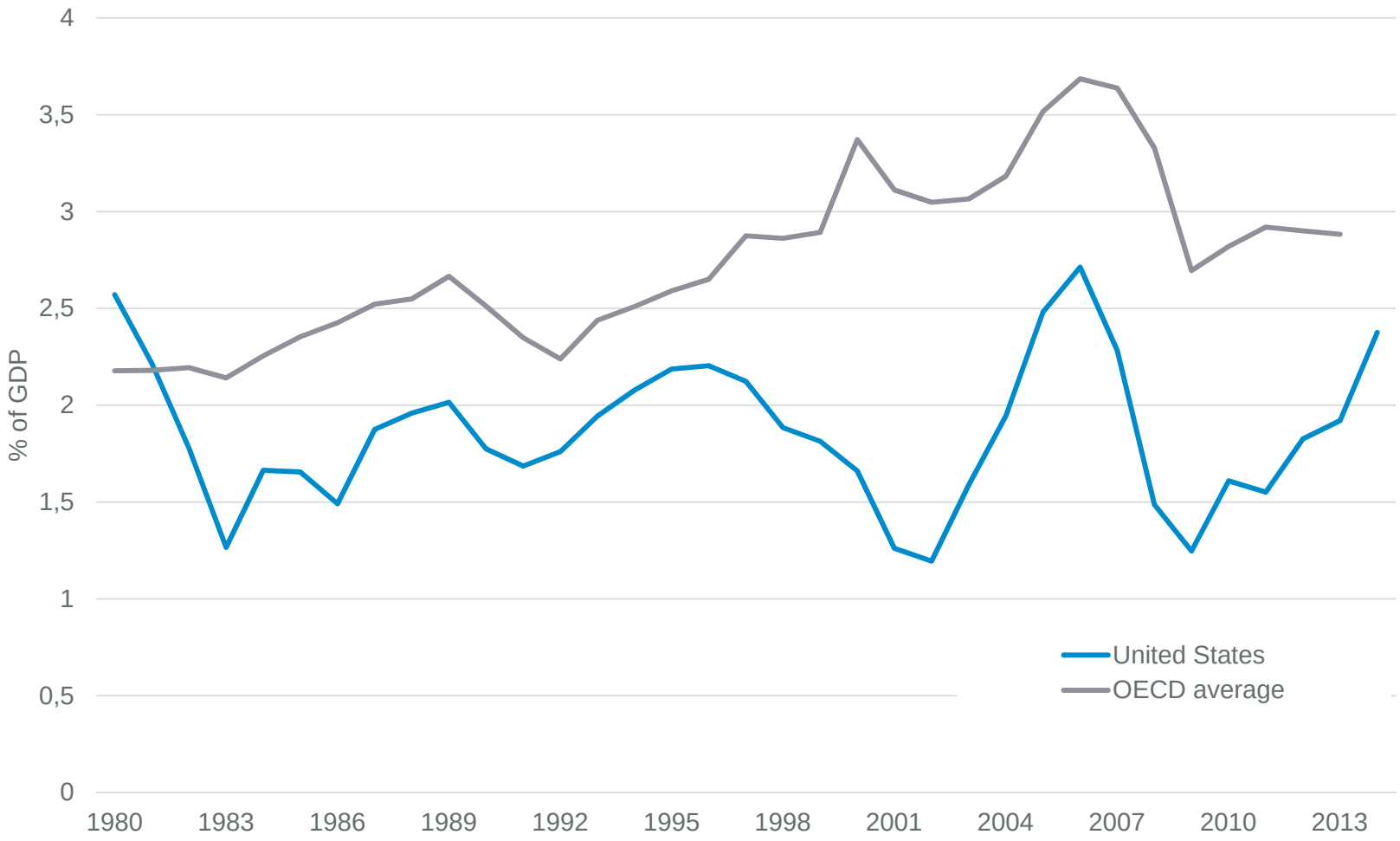
How lower corporate tax rates generate higher worker pay



Higher Tax Rates Lead to Lower Wages for Workers

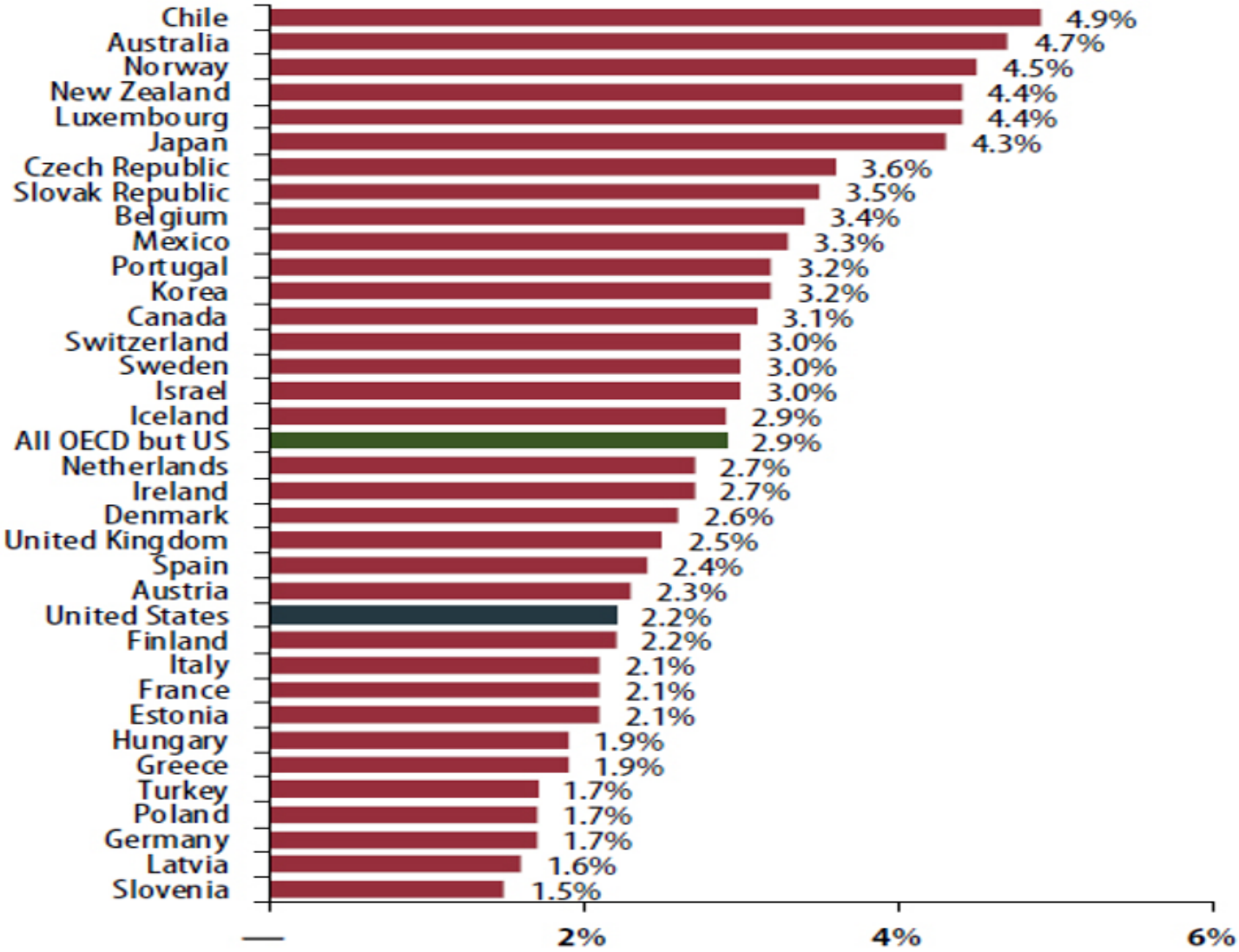
- Arulampalam et al. (2007) use company level data for nine major European countries for the period 1996-2003. Their results suggest that $1 of additional tax reduces wages by 49 cents in the long run.
- Mihir A. Desai, C. Fritz Foley, and James R. Hines (2007) use aggregate data on the activities of US companies in around 50 countries in four years to estimate jointly the impact of the corporate income tax on the wage rate and the rate of profit. Fixing the sum of these effects to be unity, they find that between 45 and 75 percent of the corporate tax borne is borne by labor with the remainder falling on capital.
- Felix (2007) also finds a large negative effect of corporate taxes on worker wages. Using cross-country panel data from the Luxembourg Income Study for 19 countries, she estimates that labor's share of the tax burden is more than four times the magnitude of the corporate tax revenue collected in the U.S.
- Carroll and Prante (2010) use data on U.S. states and finds a negative effect. A $1 increase in taxes leads to a $2.5 decline in wages.
- Hassett and Mathur (2015): empirical results indicate that domestic corporate taxes are negatively and significantly related to wage rates across countries. A 1 percent increase in the corporate tax rate is associated with a nearly 0.5 percent decrease in the hourly wage rate.

Corporate Tax Revenue as a Share of GDP (1980-2013)



Source: OECD, Revenue Statistics, Comparative Tables, http://stats.oecd.org/Index.aspx?DataSetCode=REV

Corporate Taxes as a Share of GDP in 2015

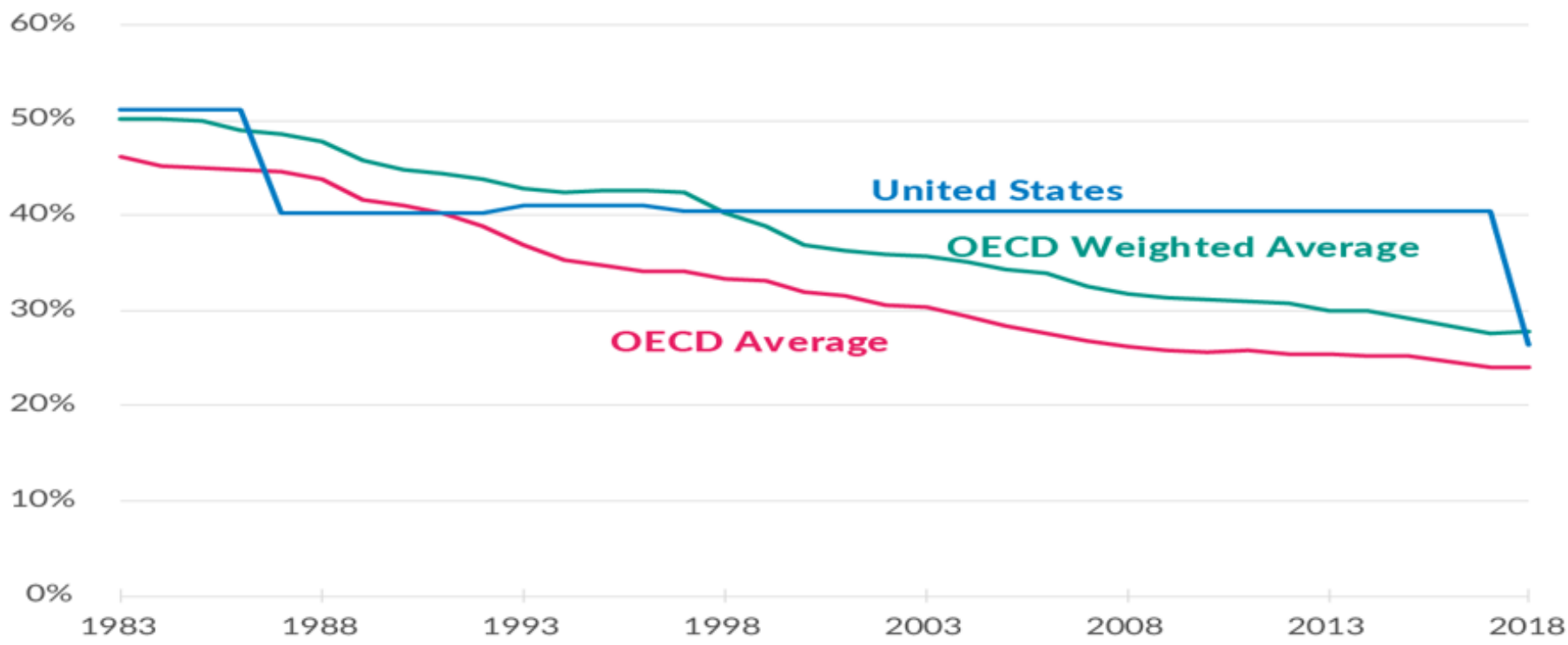


Notes: 2014 data is used for Australia, Greece, and Poland due to lack of more recent data.
Source: OECD data, http://stats.oecd.org/; 2017.

Impact of TCJA on Corporations

- Cut in the headline rate to 21 percent from 35 percent
- Expensing
- "Territorial" System of taxation
- One-time repatriation tax
- FDII
- GILTI
- BEAT

Top Statutory Corporate Income Rate, 1983-2018



Source: CBT Tax Database, OECD Statistics, USDA ERS International Macroeconomic Data Set, and Author's Calculations

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Effective Tax Rates Post-TCJA

Projections of Effective Marginal Federal Tax Rates

Percent

	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Labor Income					
Rate Under Prior Law	29.4	29.5	29.7	29.8	30.0	30.1	30.2	30.4	30.5	30.6	30.7
Rate Under the 2017 Tax Act	27.2	27.4	27.6	27.7	27.9	28.1	28.2	28.5	30.6	30.7	30.8
Difference (Percentage points)	**-2.2**	**-2.2**	**-2.2**	**-2.1**	**-2.1**	**-2.0**	**-1.9**	**-1.9**	*	**0.1**	**0.1**
						Capital Income					
Rate Under Prior Law	16.5	16.8	17.9	17.9	17.9	17.9	17.9	17.9	17.9	18.0	18.0
Rate Under the 2017 Tax Act	14.7	14.7	14.6	14.5	15.4	15.7	16.1	16.5	16.0	16.5	16.5
Difference (Percentage points)	**-1.8**	**-2.1**	**-3.3**	**-3.4**	**-2.5**	**-2.2**	**-1.9**	**-1.4**	**-1.9**	**-1.5**	**-1.5**

Source: Congressional Budget Office.

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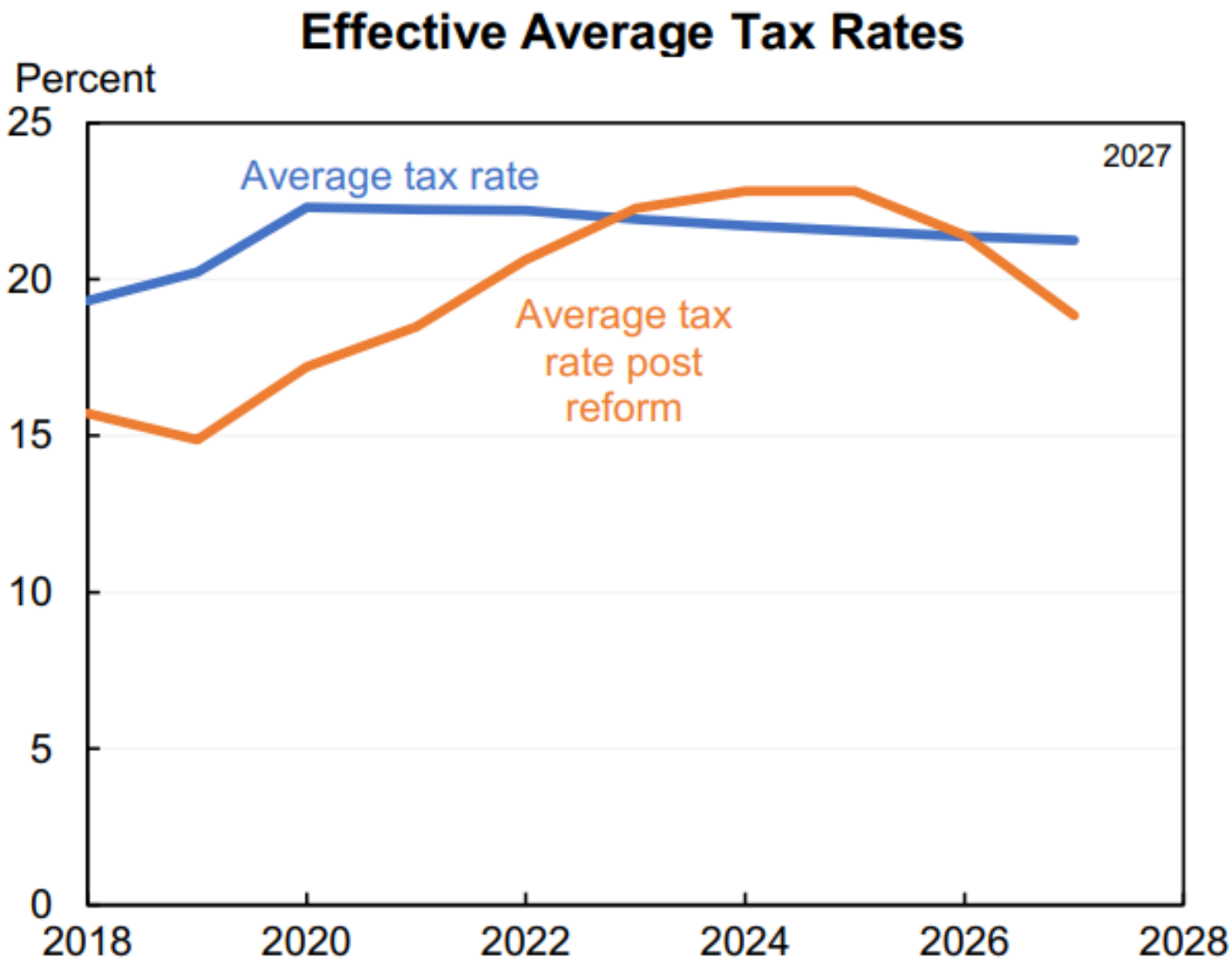


Source: Jason Furman's calculations based on Congressional Budget Office's June 2017 Economic Projections and the JCT score of the TCJA

Note: Average rates are corporate taxes divided by domestic corporate profits based on CBO projections. Analysis assumes that all of the provisions of the Tax Cuts and Jobs Act classified as "Business" and "International" by CBO are reflected in corporate taxes, an approximation since a small fraction of those provisions are not corporate.

Expensing

- Under TCJA, short-lived investments, such as machines and equipment, are eligible for 100% expensing or bonus depreciation.
- This is in effect for five years, and then will begin phasing out, and will expire at the end of 2026.
- This might pull investments forward that will result in faster growth in earlier years, and that will slow down later as the provision phases out
- If the provision were made permanent, this would have been very pro-growth because of its investment impact (perhaps more so than a corporate rate cut where the benefits are split between old and new capital)
- Under TCJA, beginning in 2021 R&D expenses must be capitalized and amortized over 5 years (15 years if the R&D is outside of the United States).
  - Previously, R&D expenses could be deducted immediately.

Pass Through Deduction

- Pre-TCJA: net taxable income from pass-through businesses (sole proprietorships, partnerships, etc.) was passed through to owners and taxed at owners' standard rates.
- TCJA: new deduction established based upon a non-corporate owner's qualified business income (QBI).
  - QBI = net qualified items of income, gain, deduction and loss from any qualified business of the non-corporate owner
- Deduction is 20% of QBI, subject to some restrictions at higher income levels.
- QBI deduction not allowed in calculating AGI of the owner, but does reduce taxable income, thus treating the deduction like an allowable itemized deduction (regardless of whether you itemize).

International Provisions and Shift to Territorial System

- Participation Exemption: Exempts foreign profits of US multinationals from domestic taxation
- The TCJA imposes a one-time tax on foreign held earnings. The tax rate is 15.5 percent for earnings held as cash or cash equivalents, and 8 percent for reinvested earnings. Can be paid over 8 years.
- Put in place anti-abuse provisions targeted at high-return foreign profits, intangible income, and income stripping
- Worldwide Minimum Tax on Intangible Income through FDII and GILTI
- BEAT: prevents MNCs from stripping income from the US tax base via excess payments to foreign-affiliated corporations

Global Intangible Low Taxed Income (GILTI)

- Applies a tax on a U.S. shareholder's CFC earnings over a notional 10 percent return on it's depreciable tangible asset base
- Aimed at reducing the incentive to shift corporate profits out of the US by using intellectual property
- Basically total CFC tested Income-0.1*QBAI
  - The second term may be thought of as the normal return to tangible investments, assuming a normal rate of 10%
  - Net CFC Tested Income is the aggregate of a U.S. corporation's worldwide foreign profits in all of its controlled foreign corporations modified to remove income already subject to U.S. tax and some income subject to high foreign tax.
- Doesn't really have much to do with intangibles or with low-income
- This income is allowed a deduction of 50%, dropping to 37.5 percent by 2025
- Taxes are further reduced by the amount of foreign tax credits (80% of all credits allowable against such income)
- Maximum US tax on GILTI is 10.5% if foreign tax credits are zero, otherwise equal to .105*GILTI-0.8*(foreign tax credits)

Foreign Derived Intangible Income (FDII)

- Aims to encourage companies to keep their intellectual property in the United States
- Domestic C-corporations in the US are allowed a deduction of 37.5 percent on their foreign derived intangible income (or excess of a deemed return on tangible income).
- FDII is typically income earned from the sale, leasing, or licensing of property for use outside the US and providing services for use outside the US.
- The tax rate on this income is therefore 13.125 percent (63.5% of 21%).
- This reduces the relative tax advantage of owning property and conducting operations in a foreign subsidiary
- After 2025, the deduction percentage decreases and the effective tax rate will increase to 16.4 percent.

Foreign Derived Intangible Income

- All C-corporations in the US are eligible for the deduction, including US subsidiaries of foreign-based multinationals.
- Starts with domestic corporations gross income
  - Deduction Eligible Income: Then deducts income under subpart F, dividends received from CFCs, and income earned in foreign branches, other deductions allocable to such incomes
  - Foreign Deduction Eligible Income: Then decide the foreign portion of that income (from sales, services income)
  - Reduce expenses attributable to that income
  - Deemed Intangible Income: Then calculate deemed intangible income as excess of deduction eligible income over 10% of QBAI
    - QBAI is basically depreciable tangible property that is used to produce the above income (except land)

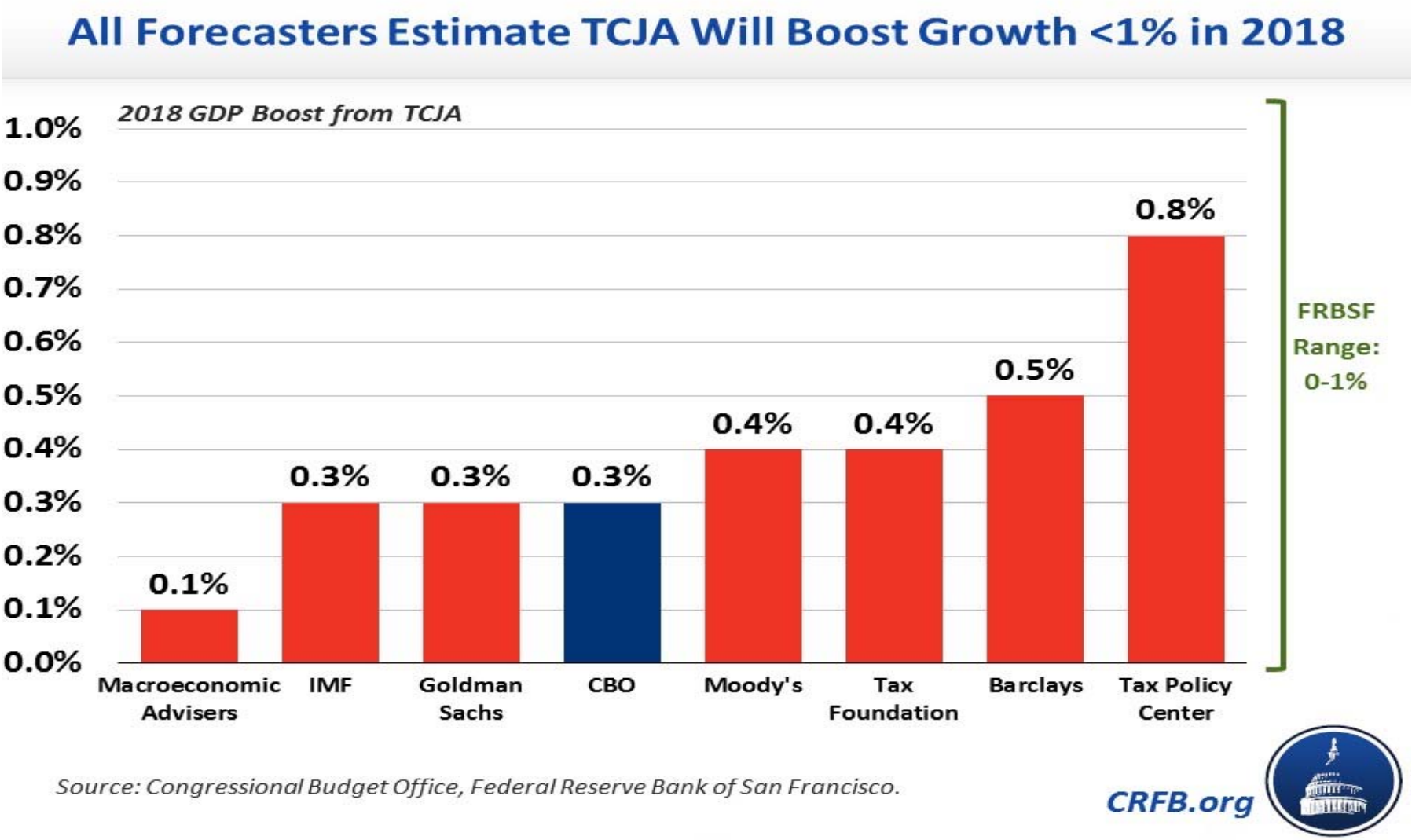
Base Erosion Anti-Abuse or Alternative Minimum Tax (BEAT)

- The Base Erosion Alternative Minimum Tax (*BEAT*), intends to limit the ability of both US and foreign-resident multinational corporations to strip profits out of their US affiliates by making deductible payments to related parties in low-tax countries ("earnings stripping").
- The BEAT is a complex alternative minimum tax of 10% (12.5% after 2025) on modified taxable income, calculated by disallowing deductibility of payments to certain related foreign parties. Payments include interest, rent, royalties, deductions for depreciation and amortization.
- It also may be challenged under WTO rules since denying deductions to foreign firms (but allowing them for domestic firms) could be considered a selective import tariff.

Long-Run Impacts on Investment, GDP and Wages

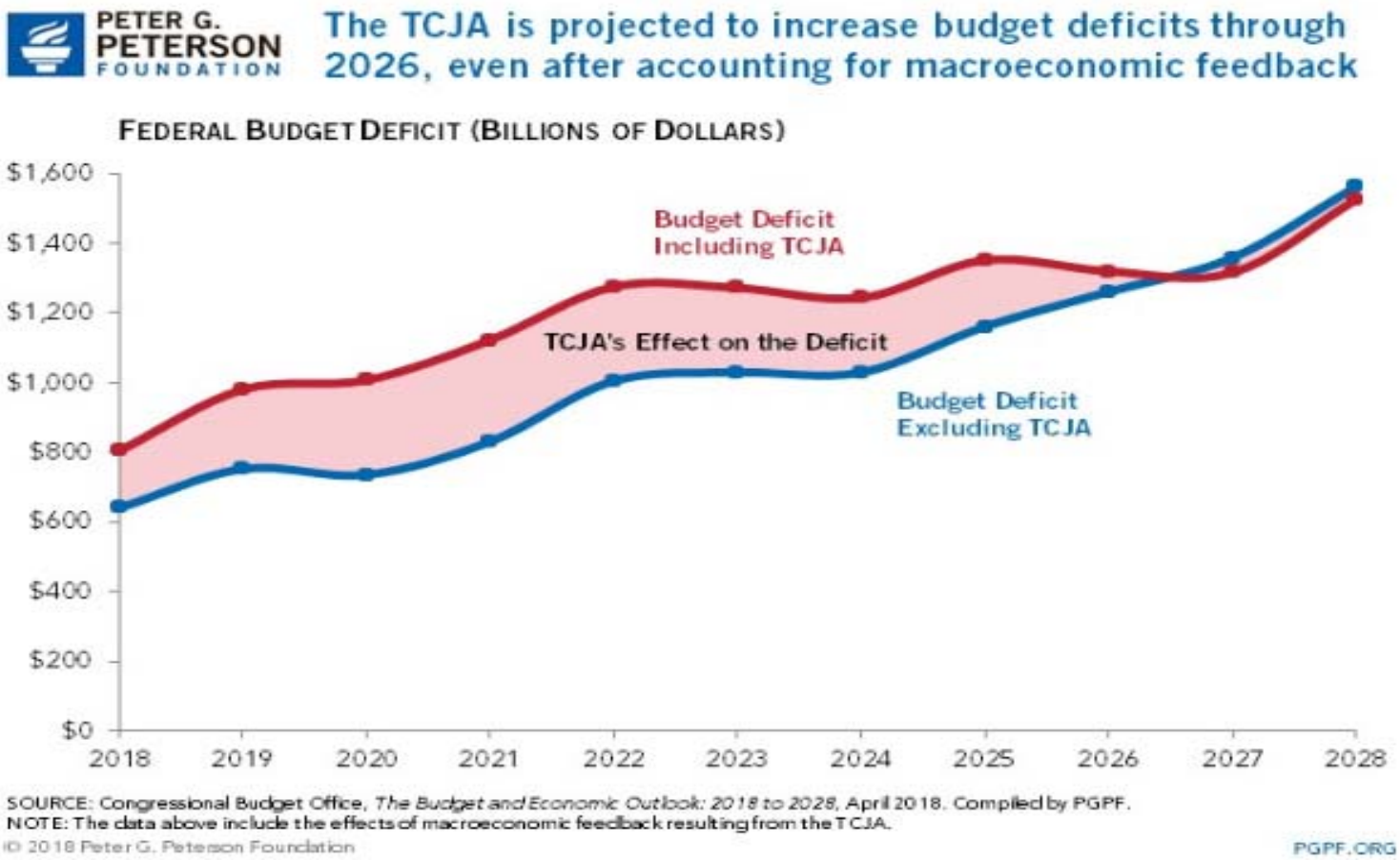
- Kallen and Mathur: In the long run, cutting the corporate tax rate to 20 percent would raise GDP and wages by 1.75 percent.
  - If they do not increase the government debt, the House tax reform's business tax provisions would raise GDP by 2.26 percent, and the Senate's version would raise GDP by 2.05 percent.
  - These impacts would be substantially increased, to 3.66 and 3.65 percent for the House and Senate bills, by making the expensing provisions in the bills permanent.
  - However, if the revenue losses in the bills are not offset by spending cuts, then the bills would increase GDP by only 1.98 and 1.74 percent.
- Barro and Furman (2018)
  - Over ten years, GDP level will increase by 0.4 percent
  - Annual growth rate would rise by 0.04 percent
  - If provisions are made permanent, then corresponding numbers are 1.2 percent and 0.13 percent

GDP Growth Projections



Effect on Debt and Deficit

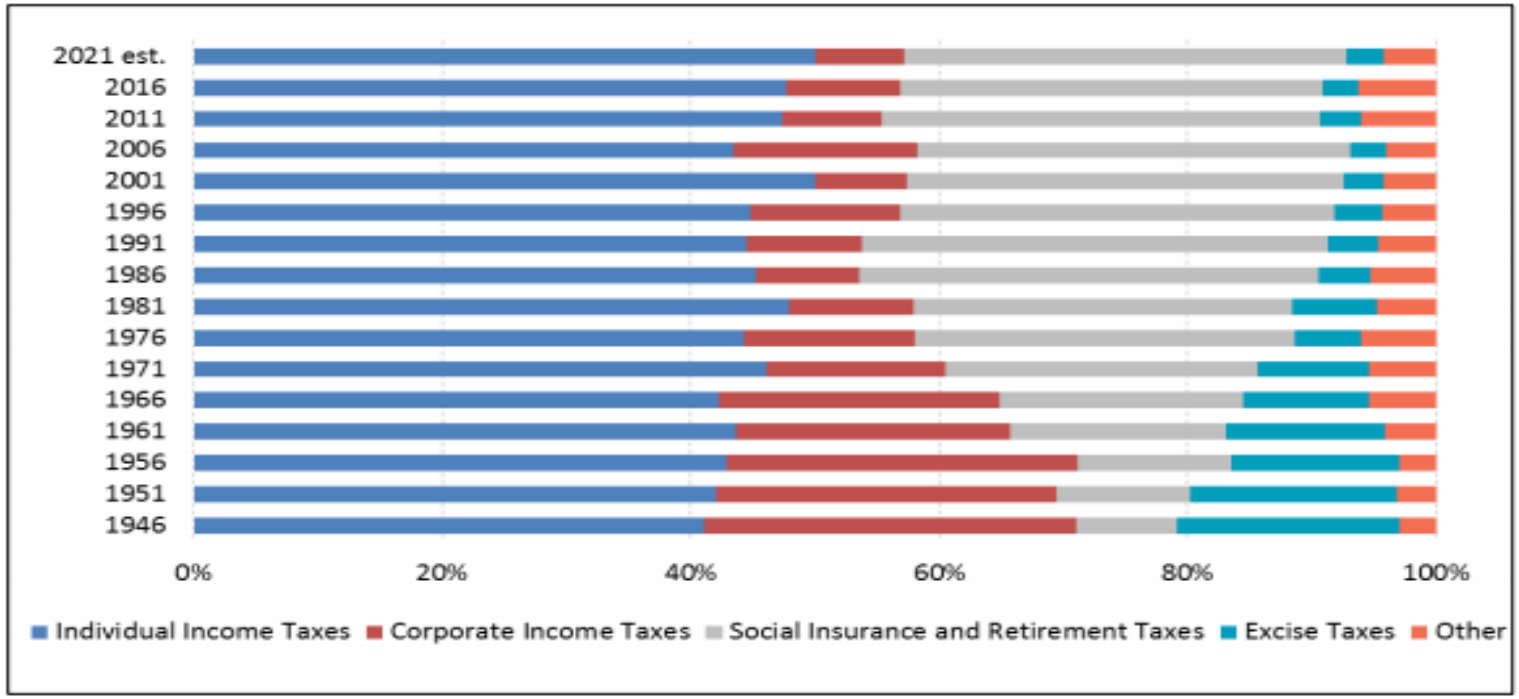
CBO calculations show TCJA provisions increase the deficit by $164 billion per year. From 2018-2028, the cumulative deficit increases will be $1.3 trillion from direct legislation effects.



Effect on Debt and Deficit

Congressional Research Service estimates that, as a share of total revenues, the corporate income tax is projected to decline further, to about 7% in 2017 (down from 9% in 2016).
This is an estimated $218 billion in revenue for fiscal year 2018.

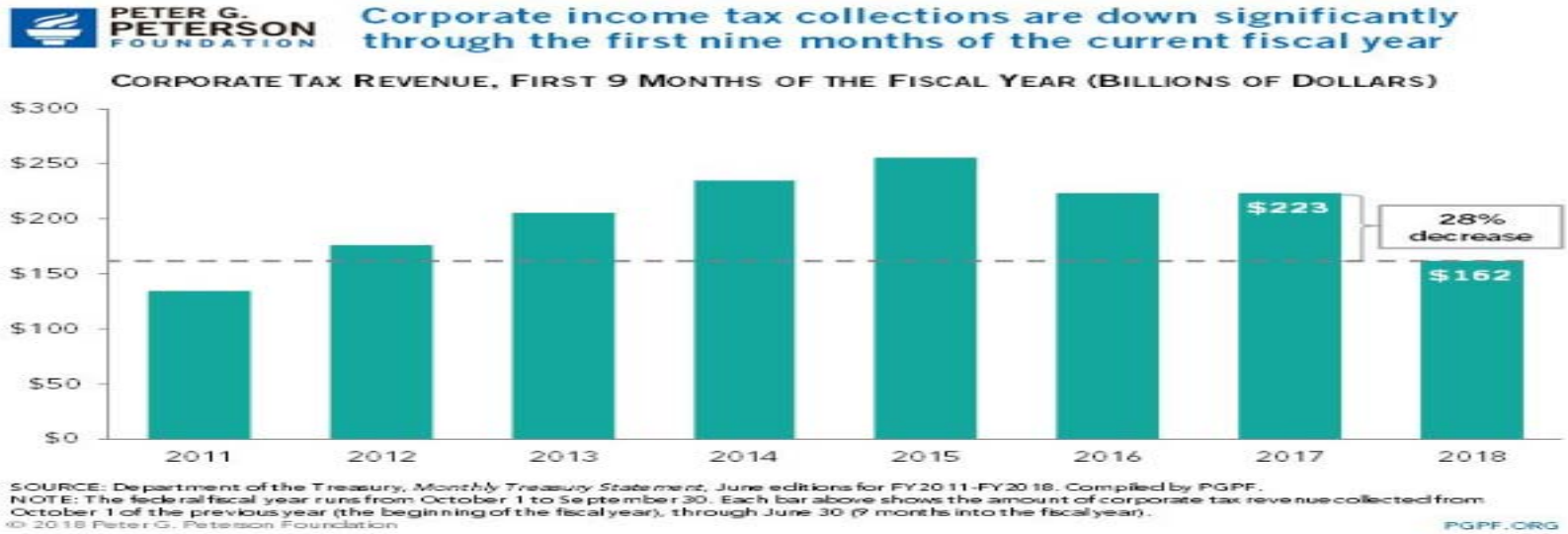
Figure 6. Composition of Federal Revenue
Selected Years 1946-2021



Source: CRS calculations using data from U.S. Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2019, Historical Tables* (Washington: GPO, 2018).

Effect on Debt and Deficit

The Department of Treasury has reported that corporate tax receipts during the first 9 months of 2018 of fiscal year 2018 have dropped 28%, from $223 billion in 2017 to $162 billion in 2018.



As anticipated, the second quarter of 2018 grew by 4.1% (fastest since 2014), which is the expected immediate stimulus from TCJA. However, many, such as Tax Policy Center, have reported that "long-term GDP impacts will be small, the after-tax income distribution will be more unequal, and the federal debt will be raised."

Effect on US MNC Investments?

- On the surface, while the rules on GILTI and FDII reduce the benefit that US multinational corporations (MNCs) can expect from locating mobile capital in low-tax jurisdictions, they do not entirely eliminate this benefit. The rules appear to leave open a tax-rate arbitrage window for mobile rents. This arbitrage arises because the marginal US tax burden on mobile rents can be no lower than 13.125% when located in the United States but can be as low as 10.5% when located in a low-tax foreign jurisdiction (other things equal). Given the dividend received deduction (DRD) under the TCJA, this means that an incentive to offshore rent-generating mobile capital may still exist among US MNCs.
- In my paper with Kartikeya Singh, we analyze whether these rules help retain internationally mobile rents within the US tax base and the associated economic activity within the United States. We compare investments with the same before-tax economic profiles when made in the United States versus when made abroad. Our analysis suggests that the provisions by themselves may still offer incentives for locating intangibles overseas.

The Shadow of BEPS

- However, locating such capital overseas in a low-tax jurisdiction can impose higher non-tax costs — which we refer to as "transaction costs" in our paper — in the international tax system of today. In particular, economic substance requirements under the OECD's BEPS regime require that reporting of taxable income tied to intangible capital in a location be supported by real activities — jobs, people and tangible capital — located in that same jurisdiction.
- Our analysis shows for a wide range of investment profiles for intangible capital, such transaction costs in conjunction with the GILTI and FDII rules will make a US MNC prefer locating the investment in the United States than a lower-tax jurisdiction. When such non-tax transaction costs are incorporated in the firm's cost-benefit calculus, the FDII rules provide a significant incentive for US firms to locate new investments within the US and the GILTI rules impose a significant burden on locating abroad. The result is that a firm's after-tax net present value from an investment is greater when locating the investment within the US than in a low-tax foreign jurisdiction.
- Furthermore, our analysis also suggests that the rules, by themselves, do not necessarily dilute the above outcome by providing significant incentives to locate new tangible capital outside of the United States.

BEPS Context: Digital Companies

- A prominent agenda item of the OECD BEPS project is the taxation of digital companies. Many countries in the European Union have expressed frustration with the fact that tech companies, such as Apple, Google, Facebook and Amazon, are able to operate and sell within their jurisdictions, but pay little or no corporate income tax. Some countries have tried to unilaterally implement measures such as a diverted profits tax, or equalization levies to tax digital activities. The US tax reform effort has put in place a provision that would provide US multinationals a lower tax rate on 'intangible income' – in reality, high profits not tied to tangible forms of capital – earned from foreign sources. Broadly speaking, the Foreign-Derived Intangible Income (FDII) rule provides a deduction of 37.5 percent to intangible income derived by domestic companies from their overseas operations, lowering a domestic corporation's effective tax rate to 13.125 percent. If this works effectively, digital companies should find it in their interest to move, not just their profits to the US, but their intellectual property as well.
- In addition, the TCJA now imposes a minimum tax on excess foreign earnings of US multinationals.
- Hence, if the aim of the BEPS project was to capture more of this intangible income in the European Union, the new US tax law will likely interfere with their efforts.

BEPS: Patent Boxes

- FDII is also a reaction to BEPS Action 5, which is aimed at developing new substance rules for patent boxes. Patent boxes are essentially means by which companies can get preferential tax treatment for certain intellectual property such as patents. The BEPS project tries to tie these kinds of preferential tax treatments to real activity, so as to discourage companies from merely shifting profits to low tax jurisdictions that offer such benefits.
- While FDII does provide a deduction on this kind of intangible activity, it does not take into account the substantial nexus (economic activity) requirement. However, given that substance requirements are becoming more important under BEPS, non-US companies should still have an incentive to meet substance requirements for any excess income claimed in the US.

BEPS Context: BEAT

- Action 4 of the BEPS project is an attempt to reduce base erosion through limitations on interest deductibility and other financial payments. The problem here is that since interest payments are tax deductible, intra-group financing within a company can lead to high levels of debt and total interest deductions that could exceed their unrelated third party interest expense. Along the same lines, the TCJA limits interest deductions for a US company to the sum of a US company's business interest income for the taxable year plus 30 percent of the company's adjusted taxable income for the year.
- In the TCJA, the base erosion and anti-abuse tax (BEAT) would further allow the Treasury to obtain information on reporting companies such as the name, place of business, countries in which related parties are resident and any base erosion payments made. The BEAT is a 10 percent minimum tax on the amount of any base-erosion tax benefits that US companies derive from transactions with non-US affiliates. It relates to any deduction that results from a payment by a US company to a related party, such as interest or royalty payments.

Conclusion

- The TCJA has dramatically changed the landscape for US multinational firms. It has pushed the US forward in terms of tackling profit-shifting, non-taxation and base erosion.
- While the US has not adopted BEPS wholeheartedly, it has adopted several unilateral measures that would reduce base erosion and profit shifting. At the same time, with a more competitive corporate tax code, the hope is that there are now strong incentives for firms to locate real economic activity in the US, as well as profits and intangible incomes.
- Questions?
  - What does this mean for European economies in terms of location of investments?
  - Will there be a race to the bottom in corporate tax rates?
  - Beyond rates, should countries offer expensing and more favorable R&D deductions to encourage investment?
  - How does this impact the fiscal picture?