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Corporate Tax Base Erosion and Profit Shifting (BEPS): An Examination of the Data

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Summary

Congress and the Obama Administration have expressed interest in addressing multinational corporations' ability to shift profits into low- and no-tax countries with little corresponding change in business operations. Several factors appear to be driving this interest. Economists have estimated that profit shifting results in significant tax revenue losses annually, implying that reducing the practice could help address deficit and debt concerns. Profit shifting and base erosion are also believed to distort the allocation of capital as investment decisions are overly influenced by taxes. Fairness concerns have also been raised. If multinational corporations can avoid or reduce their taxes, other taxpayers (including domestically focused businesses and individuals) may perceive the tax system as unfair. At the same time, policymakers are also concerned that American corporations could be unintentionally harmed if careful consideration is not given to the proper way to reduce profit shifting.

Consistent with the findings of existing research, the analysis presented in this report provides indications that the magnitude of profit shifting may be significant. For example, of the $1.2 trillion in overseas profits American companies reported earning in 2012, $600 billion was attributed to seven tax havens: Bermuda, Ireland, Luxembourg, the Netherlands, Singapore, Switzerland, and the U.K. Caribbean Islands. The Netherlands was the most popular location to report profits, accounting for 14.1% of all overseas earnings of American companies. Further analysis reveals that the share of profits reported is significantly disproportional to the amount of hiring and investment made by American companies in these countries.

Data on the foreign direct investment (FDI) positions of American companies are also analyzed. Examining FDI data allows for an indirect investigation into the degree of profit shifting. The FDI data show that the same seven tax haven countries accounted for nearly half (47%) of the worldwide FDI position of the United States. The data also show that an increasing share of FDI is being held via holding companies. The report discusses that some of the increased use of holding companies may be tax motivated. Lastly, data from the International Monetary Fund (IMF) and the United Nations (UN) on the location of the FDI positions of all countries indicate that profit shifting is likely an international issue.

Several policy options for addressing base erosion and profit shifting are briefly discussed. Included in the discussion are the tradeoffs and considerations involved in moving closer to either a pure worldwide tax system or a pure territorial tax system. The adoption of a minimum tax or a formula apportionment system is also discussed, as well as the effects of modifying current tax policy such as broadening the definition of Subpart F income or reducing corporate tax rates. The report concludes with a discussion of the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) plan, which may have implications for American corporations even if the U.S. does not adopt the OECD's recommendations.

This report is intended to assist Congress as it considers what, if any, action to take to curb profit shifting. It is one of several CRS products related to the subject of profit shifting. Where appropriate, reference is made to related CRS products that discuss the more technical issues in the international corporate tax debate.

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Introduction

It has been reported with increasing frequency that American corporations are engaging in profit shifting. That is, they are using tax planning strategies to avoid, delay, or reduce their U.S. tax on income earned overseas. Included among the companies that have been mentioned are Amazon, Apple, Caterpillar, Cisco, Google, Pfizer, and Starbucks, along with a number of other well and not-so-well known businesses.[1] To curb profit shifting, some have argued for disallowing the sophisticated techniques companies use, as either part of a broader tax reform plan, or as separate legislation; presumably the separate legislation would be a stop-gap measure put in place until potential tax reform takes place. Others have argued that it is the current U.S. corporate tax rate and general approach to taxing American multinational corporations (MNCs) that is encouraging companies to shift profits and keep money abroad. The best remedy, it is argued, is to reduce the corporate rate and consider excluding most foreign earned income from taxation. This approach has also been offered as a broader tax reform package. Thus far, there is no consensus on the best way to reduce profit shifting.

Profit shifting is not exclusively a U.S. problem. Foreign policymakers have also voiced concern over the tax strategies employed by U.S. corporations operating in their markets, as well as their own domestically based corporations. For example, in 2012, the Public Accounts Committee of the British House of Commons called upon executives from Amazon, Google, and Starbucks to explain their companies' U.K. tax strategies.[2] German Chancellor Angela Merkel urged action to curb corporate profit shifting in a speech at the Organisation for Economic Co-operation and Development (OECD) on February 19, 2014.[3] Similarly, French President François Hollande has called for some form of global tax harmonization.[4]

In response to the growing international concern, the OECD was asked by the G20 finance ministers to develop an Action Plan on Base Erosion and Profit Shifting (BEPS).[5] The goal is to develop 15 detailed actions governments can take to reduce tax avoidance by multinational corporations (as well as individuals) worldwide. The Action Plan is scheduled to be completed in three phases: September 2014, September 2015, and December 2015. Some of the actions will require coordination and information sharing between governments, and potentially the amendment of existing tax treaties. As a result, the Action Plan relies heavily on the participation

[1] For example, see Charles Duhigg and David Kocieniewski, "How Apple Sidesteps Billions in Taxes," *The New York Times,* April 28, 2012, p. A1; Jesse Drucker, "Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes," Bloomberg, October 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html/; Jesse Drucker, "IRS Auditing How Google Shifted Profits Offshore to Avoid Taxes," *Bloomberg*, October 13, 2011, http://www.bloomberg.com/news/2011-10-13/irs-auditing-how-google-shifted-profits-offshore-to-avoid-taxes.html; and Richard Rubin, "Profit Shifting: Moving to Cut U.S. Taxes," *Bloomberg*, February 18, 2015, BloombergQuickTake.

[2] House of Commons, Committee Public Accounts, *HM Revenue & Customs: Annual Report and Accounts 2011-12*, Nineteenth Report of Session 2012-1, November 28, 2012, http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf.

[3] The Federal Government of Germany, "Speech by Federal Chancellor Angela Merkel to the OECD Conference," February 19, 2014, http://www.bundesregierung.de/Content/EN/Reden/2014/2014-02-19-oecd-merkel-paris_en.html.

[4] "France will not tolerate tax avoidance, says Francois Hollande," *The Telegraph*, February 6, 2014, http://www.telegraph.co.uk/finance/personalfinance/tax/10622933/France-will-not-tolerate-tax-avoidance-says-Francois-Hollande.html.

[5] For more information on the G20, see CRS Report R40977, *The G-20 and International Economic Cooperation: Background and Implications for Congress*, by Rebecca M. Nelson.

of all major economies. A number of G20 countries that are not part of the OECD (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, and South Africa) participated in the meetings that led to the eventual adoption of the Action Plan by all G20 finance ministers.

This report is intended to assist Congress as it considers what, if any, action to curb profit shifting. Data on the operation of U.S. and foreign corporations are analyzed to understand where profit may be being shifted to and to what extent. There are indications that profits are being shifted to "tax-preferred" or "tax-haven" countries, and that the amount of profits involved (and therefore the tax revenue lost) could be considerable.[6] This report discusses the methods used for shifting profits only to the extent that it is necessary for interpreting the data or discussing policy options. For a detailed discussion of the profit-shifting mechanisms used by corporations, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

Overview of the U.S. International Corporate Tax System

The United States, in theory, taxes American corporations on their worldwide income.[7] This approach to taxation is referred to as a worldwide (or resident-based) tax system. In contrast, a territorial (or source-based) system would tax American corporations only on income earned within the physical borders of the United States. In reality, no major economy has a pure worldwide or a pure territorial tax system.[8]

Although the U.S. taxes the worldwide income of American corporations, current law allows taxes to be deferred on income earned abroad until that income is repatriated (returned) to the United States.[9] Deferral is a benefit to American corporations because delayed taxes are a reduced tax expense to firms due to the time value of money.[10] In the extreme, deferral could allow an American corporation to completely avoid U.S. taxation on foreign source income if they never repatriate their overseas income, either because the income is being held abroad in financial assets or because it is permanently reinvested (e.g., in plant and equipment). The income earned by foreign branches of American corporations, however, cannot be deferred.[11]

[6] "Tax haven" is not a precisely defined term, but in most usages it refers to a country—in many cases a small one—where nonresidents can save taxes by conducting various investments, transactions, and activities. Attributes that may make a country a successful tax haven include low or nonexistent tax rates applicable to foreigners; strict bank and financial secrecy laws; and a highly developed communications, financial, and legal infrastructure.

[7] The concepts discussed here are described in greater detail in CRS Report R41852, *U.S. International Corporate Taxation: Basic Concepts and Policy Issues*, by Mark P. Keightley and Jeffrey M. Stupak, and CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle.

[8] For a discussion of whether the distinction between worldwide and territorial systems is still valid, see Kimberly A. Clausing, "Beyond Territorial and Worldwide Systems of International Taxation," *Working Paper*, February 2015, at http://ssrn.com/abstract=2567952.

[9] Repatriation is technically accomplished via a dividend payment from a foreign subsidiary to its American parent corporation.

[10] The economic concept of the "time value of money" states that a dollar today is more valuable than a dollar in the future.

[11] A foreign subsidiary is a legal entity separate from its parent company, while a foreign branch is an extension of a domestic company.

A particular type of income which does not qualify for deferral is known as "subpart F income." Named for the location in the Internal Revenue Code (IRC) where its tax treatment is defined, subpart F income generally includes passive types of income such as interest, dividends, annuities, rents, and royalties.[12] The highly fungible nature of subpart F income is such that corporations can use overseas subsidiaries to transfer taxable income from high-tax countries to low-tax countries with the ultimate goal of reducing their U.S. income tax liability. To prevent this, corporations must pay taxes on subpart F income in the year it is generated, regardless of whether it is actually repatriated to the United States.[13]

A temporary exception to the subpart F income tax rules for "active financing income" existed for income earned between 1997 and 2014. The active financing exception relates to the income earned by American corporations that operate banking, financing, and insurance lines of business abroad. Although some of the income derived from these lines of business (e.g., interest, dividends, and annuities) could be labeled as passive, active financing income was excepted from subpart F, and thus qualified for deferral and was only taxed when it was repatriated to the United States. The exception was last extended retroactively through 2014 by P.L. 113-295 in the 113th Congress, and has regularly been extended in recent years as part of "tax extenders" legislation.

When American corporations repatriate income from subsidiaries operating abroad, that income may have already been taxed by a foreign country. If it has, corporations are generally allowed to claim a dollar-for-dollar tax credit (up to a limit) for foreign taxes paid. The credit, formally known as the foreign tax credit, is intended to alleviate the double taxation of corporate income.[14] The credit is generally limited to the amount of taxes a corporation would pay in the credit's absence, which is effectively just the U.S. corporate tax rate multiplied by the amount of income earned abroad. In other words, an American corporation may claim the foreign tax credit up to the point that reduces its U.S. tax on foreign-earned income to zero, but no further. Additionally, a separate credit must be calculated for two types of income "baskets"—passive and non-passive income.

As long as the U.S. corporate tax rate is higher than the foreign country's rate, the foreign tax credit should—in principle—result in the corporation owing the same amount in total taxes (U.S. plus foreign) as it would if it earned the income in the Unites States. When the foreign tax rate is higher than the U.S. tax rate, a corporation should end up paying total world taxes (U.S. plus foreign) at a tax rate higher than the U.S. rate. There are instances when a corporation could end up with "excess" foreign credits because of the limits that restrict the credit from reducing U.S. taxes owed below zero. Excess foreign tax credits generated in a high-tax country can potentially be used to reduce U.S. tax owed on income generated in a low-tax country via a process known as "cross crediting." This is possible because deferral allows corporations to selectively decide when to repatriate income and therefore when to use excess credits.

[12] Specifically, the tax treatment of subpart F income may be found in Sections 951 to 956 of the IRC.

[13] A rule called "check-the-box" has undermined subpart F provisions by allowing foreign subsidiaries to make transactions between themselves, such as loans and royalty payments, which are not recognized as taxable transactions by law. With check-the-box a corporation can set up a foreign subsidiary that owns another foreign subsidiary. The company then "checks a box" on an IRS form choosing to have the lower-level subsidiary treated as a disregarded (fiscally transparent) company for tax purposes. Transactions between the two subsidiaries are then treated as if they are occurring within the same company, avoiding the subpart F anti-deferral rules.

[14] Sections 901 to 909 of the IRC define the foreign tax credit rules.

Indications of Profit Shifting by American MNCs

The tax returns of American corporations are private, which makes it difficult to study profit shifting directly. Several publically available datasets, however, do allow for an indirect examination into the extent that profit shifting may be occurring. The U.S. Bureau of Economic Analysis (BEA) collects data on the financial operations of American MNCs, including information on where they report profits, employ workers, make investments, conduct research and development, and carry out various other activities. The BEA also collects country-level data on the foreign direct investment (FDI) positions of U.S firms. The following sections discuss these data in turn.

BEA Corporate Profits by Country

American companies reported earning profits of just over $1.2 trillion abroad in 2012 according to the BEA. **Table 1** shows that the 10 most popular places to report profits were responsible for approximately 65% (or $789 billion) of the total $1.2 trillion in overseas earnings. Seven of the 10 reporting jurisdictions are considered "tax havens" or "tax-preferred" countries, including the four most popular destinations: the Netherlands, Ireland, Luxembourg, and Bermuda. The other three tax-preferred countries are Switzerland, Singapore, and the U.K. Caribbean Islands.[15] Among the non-tax-preferred countries, the United Kingdom and Canada are major industrialized nations that are historically close trading partners with the United States. Norway is the biggest oil producer in Europe and the third largest exporter of natural gas in the world, which explains its placement on the list.[16]

Table 1. Ten Most Popular Places to Report Profits for U.S. Companies, 2012

Rank	Country	Profits (millions)	Profits as % of Total Overseas Profits
1	Netherlands	$172,250	14.1%
2	Ireland	$122,328	10.0%
3	Luxembourg	$96,079	7.9%
4	Bermuda	$79,706	6.5%
5	United Kingdom	$74,141	6.1%
6	Canada	$70,782	5.8%
7	Switzerland	$57,930	4.7%
8	Singapore	$42,395	3.5%
9	UK Caribbean Islands	$40,881	3.4%
10	Norway	$32,961	2.7%

[15] For more information on tax havens, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

[16] U.S. Energy Information Administration, *Norway Analysis Brief*, April 28, 2014, http://www.eia.gov/countries/cab.cfm?fips=NO.

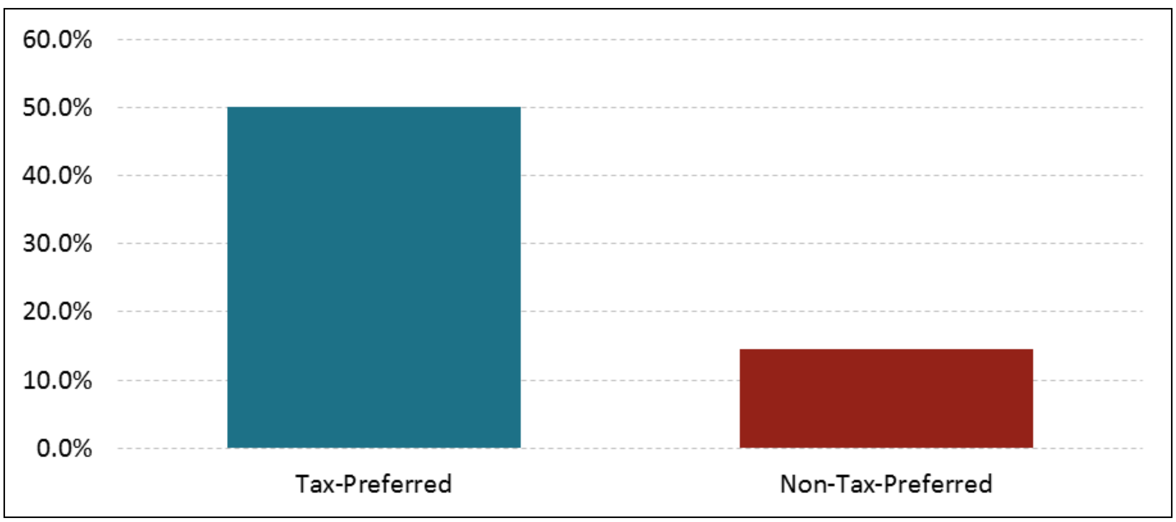
Rank	Country	Profits (millions)	Profits as % of Total Overseas Profits
Top 10		**$789,453**	**64.7%**
All Foreign Countries		**$1,219,956**	**100.0%**

Source: CRS analysis of U.S. Bureau of Economic Analysis, Outward Activities of Multinational Enterprises: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2012 Statistics.

Notes: Profits are measured as net income plus foreign taxes paid. The United Kingdom Caribbean Islands group is comprised of Cayman Islands, the British Virgin Islands, Turks and Caicos Islands, and Montserrat. The BEA does not break out data for the individual United Kingdom Caribbean Island countries.

Figure 1 shows the distribution of profits reported abroad in the same 10 jurisdictions displayed in **Table 1**. The distribution is divided into two groups—one that includes the seven tax-preferred jurisdictions and another that is comprised of the three non-tax-preferred jurisdictions. The tax-preferred jurisdictions accounted for 50% of all profits reported as being earned outside the United States, in comparison to the 15% being reported in the three non-tax-preferred jurisdictions. At first glance, the fact that the seven tax-preferred jurisdictions are responsible for a larger share of reported profits may not seem surprising—a larger number of countries should account for a larger share of profits. But consider that the combined economic size of the tax-preferred group (as measured by GDP) is less than one-half that of the non-tax-preferred group ($2.23 trillion to $4.86 trillion).[17]

Figure 1. Share of Foreign Earned U.S. Corporate Profits in Top-10 Jurisdictions (2012)



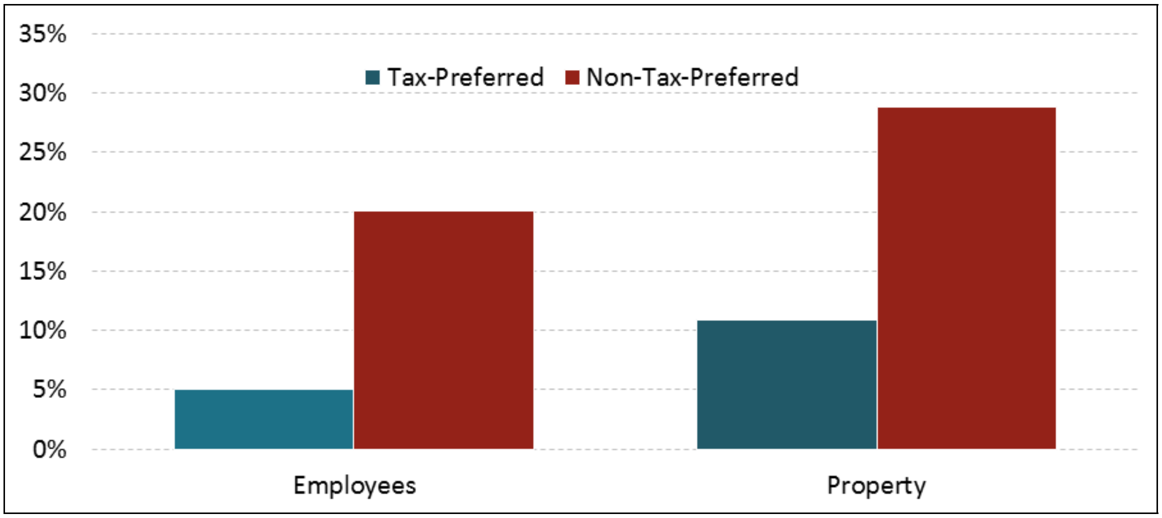
Source: CRS analysis of U.S. Bureau of Economic Analysis, Outward Activities of Multinational Enterprises: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2012 Statistics.

Notes: Profits are measured as net income plus foreign taxes paid. The tax-preferred group includes Bermuda, Ireland, Luxembourg, Netherlands, Singapore, Switzerland, and the U.K. Caribbean Islands. The non-tax-preferred group includes Canada, Norway, and the United Kingdom.

[17] Data come from the United Nations Conference on Trade and Development Statistics, 2013.

Figure 2 displays the share of workers hired and the share of property, plant, and equipment owned by American companies outside of the United States in both country groups. Comparing where American firms report profits (**Figure 1**) with where they have a physical presence as measured by the location of their employees and tangible capital indicates a disconnect between the two. While accounting for 50% of reported profits reported worldwide, 5% of employees and 11% of property can be attributed to the tax-preferred country group. In contrast, the three non-tax-preferred countries of Canada, Norway, and the United Kingdom account for 20% of employees and 29% of property held by American MNCs worldwide.

Figure 2. Employment and Property in Top-10 Profit Jurisdiction Groups as a Percentage of Foreign Employment and Investment of American MNCs (2012)



Source: CRS analysis of U.S. Bureau of Economic Analysis, Outward Activities of Multinational Enterprises: Operations of U.S. Parent Companies and Their Foreign Affiliates, Preliminary 2012 Statistics.

Notes: Profits are measured as net income plus foreign taxes paid. The tax-preferred group includes Bermuda, Ireland, Luxembourg, Netherlands, Singapore, Switzerland, and the U.K. Caribbean Islands. The non-tax-preferred group includes Canada, Norway, and the United Kingdom.

U.S. Foreign Direct Investment by Country

Data on the foreign direct investment (FDI) behavior of American MNCs can also shed some light on possible profit-shifting activity. FDI generally involves a multinational corporation's investment in its foreign subsidiaries.[18] There are a number of types of investments that can be categorized as FDI and not all of them are associated with profit shifting. For example, investments in real physical capital such as production plants and equipment are counted as FDI. At the same time, FDI also captures financial flows within a company group such as reinvested earnings and intra-company loans that may or may not be supporting real capital investment. It is these financial flows that cannot be tied to corresponding real investment that economists believe may be an indication of profit shifting.

[18] The other major category for international capital flows is foreign portfolio investment which mainly involves individual investment in foreign securities.

To qualify as FDI, the parent corporation must have an ownership and controlling stake in the foreign entity it is investing in. Currently, the BEA and other international statistical agencies (e.g., International Monetary Fund) require that the domestic parent hold a minimum 10% ownership interest in the foreign "affiliate" to categorize an investment as FDI.[19] The ownership of the foreign affiliate by the domestic parent can be either direct or indirect. An example of indirect ownership would be if the American parent established a foreign holding company which in turn owned several foreign affiliates. In this case, the American parent would still be considered to hold an FDI position in the countries where the foreign affiliates were located. Thus, FDI activity in particular countries could be indicative of funds being channeled through intermediate firms within a holding company group. Tax planning is one of the possible motivations for this corporate structure.

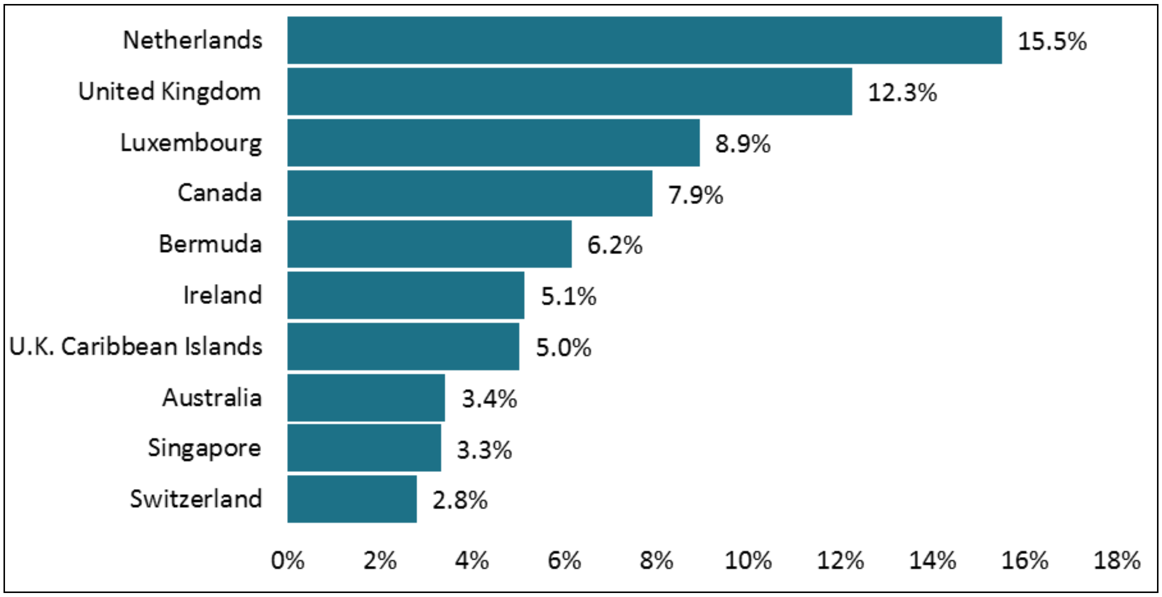
Shown in **Figure 3** are the 10 countries with the largest positions of U.S. FDI. American MNCs are reporting a significant share of their FDI as occurring in tax-preferred countries. The seven tax-preferred countries—Netherlands, Luxembourg, Bermuda, Ireland, United Kingdom Caribbean Islands, Singapore, and Switzerland—accounted for 47% of the FDI positions of American companies, compared to 24% for the three larger industrialized nations of the United Kingdom, Canada, and Australia. Perhaps most interesting is that the Netherlands, while only a fraction of the economic size, holds more American FDI than Australia, Canada, and the United Kingdom.[20] FDI flow data (or change in FDI over a given point of time) show similar type patterns.[21]

[19] The U.S. parent must own at least 10% of the foreign company's voting securities if it is a corporation or an equivalent interest if the foreign company is unincorporated.

[20] The Dutch economy is 53% the size of Australia's, 44% the size of Canada's, and 32% the size of the U.K.'s according to data from the United Nations Conference on Trade and Development Statistics, 2013.

[21] FDI position data was used because they are less susceptible to year-to-year fluctuations.

Figure 3. U.S. FDI Positions as a Percentage of Total U.S FDI Positions Held Abroad, by Country (2013)



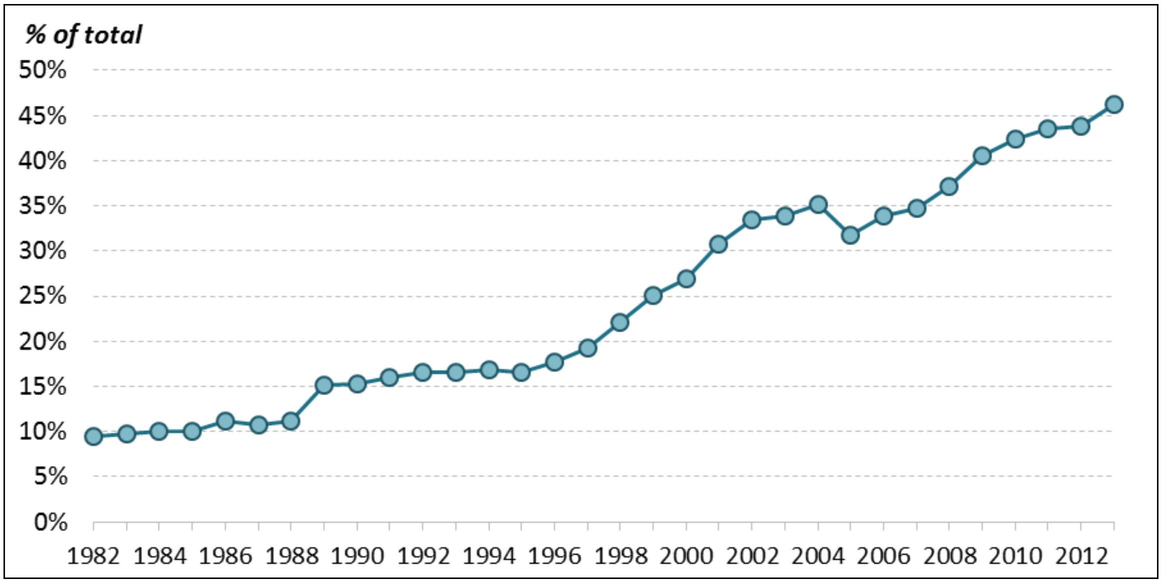
Source: CRS analysis of U.S. Bureau of Economic Analysis, U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data.

U.S. Foreign Direct Investment Held Through Holding Companies

An increasingly popular way American companies have been structuring their operations and foreign investments is through the use of holding companies. In its simplest form, a holding company is an entity established to own the securities and assets of other companies.[22] The companies under the umbrella of a holding company can be located anywhere in the world. The holding company, in turn, is owned by a U.S. parent that is then deemed to have an indirect ownership or investment interest in the jurisdiction where the holding company's subordinates are located. **Figure 4** shows that over the last 30 years, the share of U.S. FDI owned through holding companies has increased from 9.4% to 46.2%.

[22] Marilyn Ibarra-Caton and Raymond J. Mataloni Jr., *Direct Investment Positions for 2013: Country and Industry Detail*, U.S. Bureau of Economic Analysis, Washington , DC, July 2014, p. 7, http://www.bea.gov/scb/pdf/2014/07%20July/0714_direct_investment_positions.pdf.

Figure 4. Share of Direct Investment Position Held Through Holding Companies (2013)

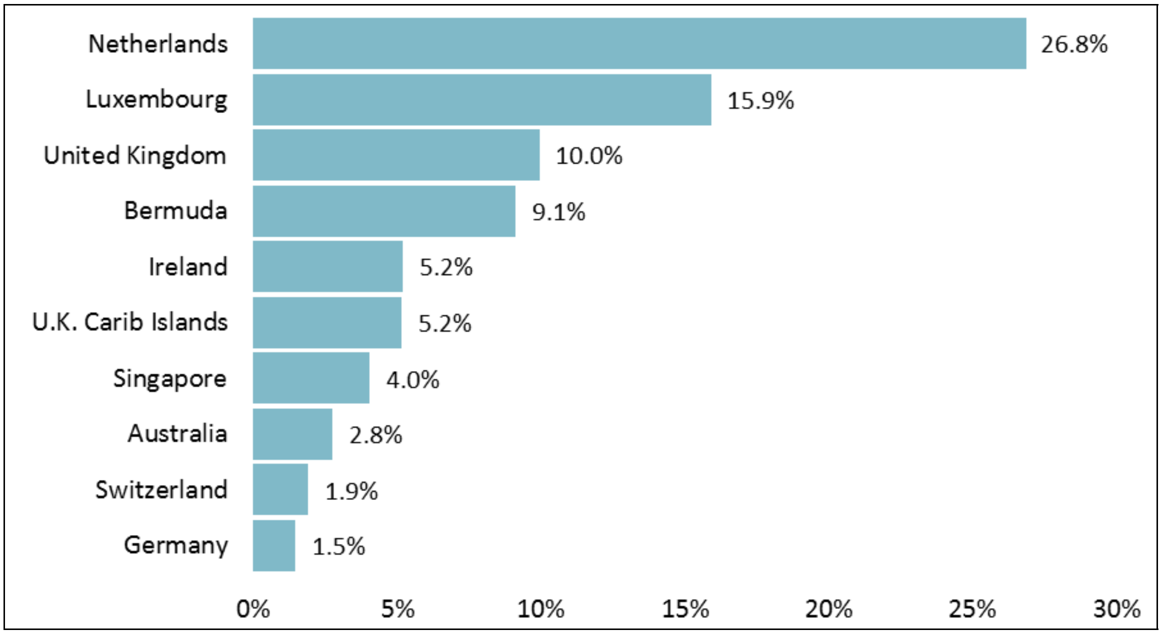


Source: CRS analysis of U.S. Bureau of Economic Analysis, U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data.

Holding companies offer two significant advantages. First, organizing a group of subsidiaries under the umbrella of a holding company can allow for the streamlining of management, operations, financing, and leasing agreements which can increase business efficiency, lower costs, and boost profitability. Second, holding companies present a number of tax minimization opportunities. For example, if a U.S. corporation owns its foreign subsidiaries through a foreign holding company instead of directly, it becomes possible to transfer funds from one subsidiary to another without triggering U.S. tax by using the holding company as the intermediary in the transfer. Another example involves placing valuable intellectual property (IP) with a foreign holding company located in a low-tax jurisdiction and then licensing the IP to other subsidiaries in higher-tax jurisdictions. This results in a deductible royalty payment in the high-tax jurisdictions and income in the low-tax jurisdiction. Numerous other examples exist as to how holding companies fit into the profit shifting picture.[23]

[23] For an accessible introduction to holding companies and tax strategies, see David Buss, David Hryck, and Robert Rothman, "International Tax Strategies," *Taxes*, April 2005.

Figure 5. Share of Direct Investment Position Held Through Holding Companies, by Country (2013)



Source: CRS analysis of U.S. Bureau of Economic Analysis, U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data.

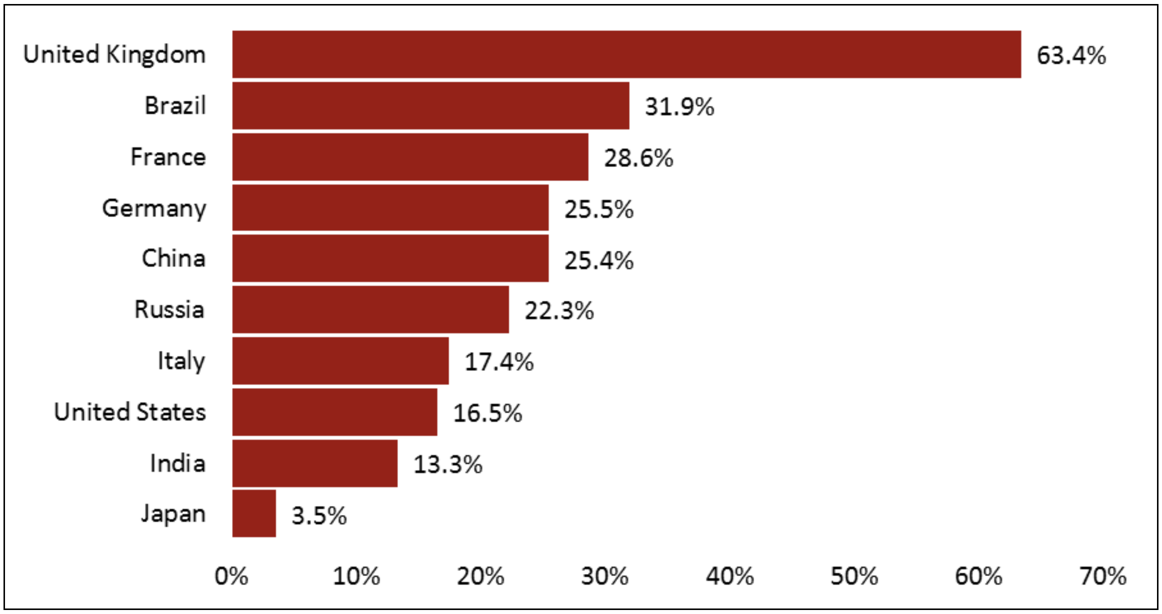
Current data limitations prevent definitively determining whether multinational companies are increasingly using the holding-company structure for non-tax business reasons or to minimize taxes. Still, it is possible to look for anomalies that may be suggestive of why holding-company use is on the rise. Shown in **Figure 5** are the 10 most favored locations through which U.S. outward FDI is held via holding companies. In 2013, the amount of the U.S. FDI position abroad that was held through holding companies was approximately $2.2 trillion. Of that $2.2 trillion, 68% (or $1.5 trillion) was attributable to the seven tax-haven or tax-preferred locations of the Netherlands (27%), Luxembourg (16%), Bermuda (9%), Ireland (5%), the U.K. Caribbean Islands (5%), Singapore (4%), and Switzerland (2%). In contrast, the three traditional economies of the United Kingdom, Australia, and Germany collectively accounted for 14% of the U.S. FDI position abroad that was held through holding-company structures.

Indications of Worldwide Profit Shifting

Data from the International Monetary Fund (IMF) suggest that corporate profit shifting is not solely a U.S. issue. As indication of this, consider a comparison of foreign investment into the 10 largest economies and the 10 most popular investment destinations. **Figure 6** displays the inward FDI positions (that is, investments in each country from the rest of the world) as a percentage of GDP for the 10 largest economies.[24] On average the 10 largest economies in the world have an inward FDI position equal to 25% of their economies. Japan has the smallest FDI position (4% of GDP), while the U.K. has the largest (63% of GDP). The United States, with the largest economy, has an inward FDI position equal to 17% of GDP.

[24] More precisely, the amount of investment from other countries that the IMF measures.

Figure 6. Inward FDI Position in10 Largest Economies as a Percentage of GDP (IMF, 2013)

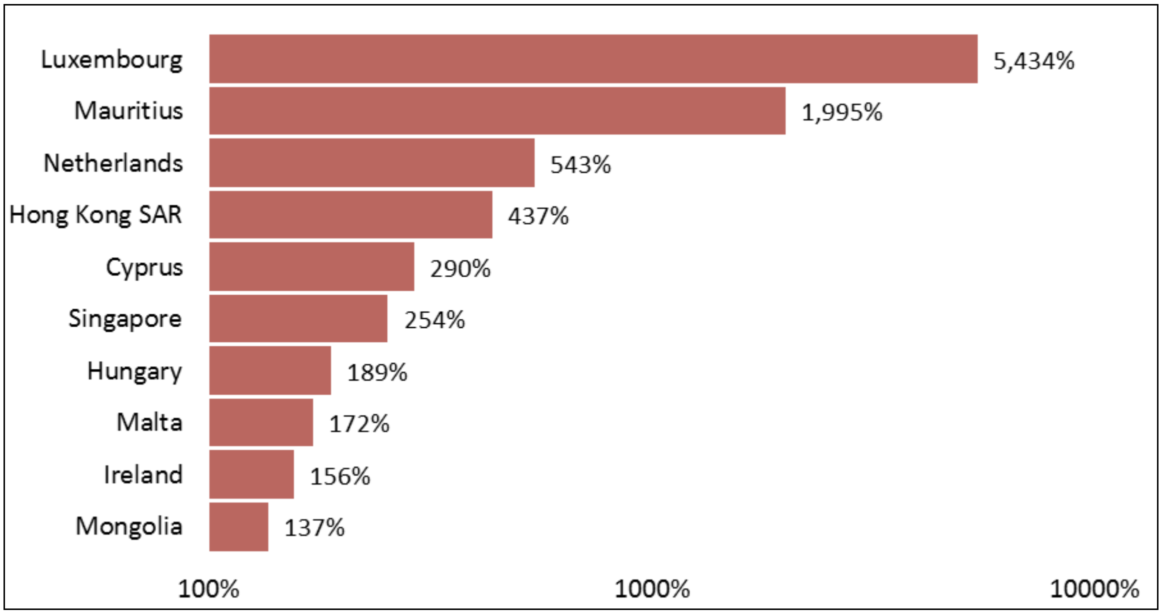


Source: CRS Analysis of IMF, World Economic Outlook Database, April 2014.

In comparison, **Figure 7** shows the inward FDI positions of the 10 most popular direct investment destinations. Again, these FDI positions are the result of investment flowing in from the rest of the world. Two features of the data are immediately apparent. First, aside from Mongolia (where mining operations have attracted capital), the most popular direct investment destinations are all tax-haven or tax-preferred countries.[25] Second, the amount of investment into these countries far exceeds investment in the 10 largest economies. For example, the countries in **Figure 7** have an average inward FDI position equal to 961% the size of their economies. The least popular tax-preferred country in the group, Ireland, had an FDI position equal to 156% of GDP, which is more than twice that of the United Kingdom (see **Figure 6**). Luxembourg had the largest FDI position (5,434% of GDP).

[25] The Netherlands and Hungary do not appear on the typical tax haven lists often cited, although many argue that they should. Again, however, since the definition of what constitutes a tax haven is not universally agreed upon, these countries can arguably be placed in the "tax-preferred" category at a minimum. For more countries over which there is similar debate, see CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

Figure 7. Inward FDI Position In10 Most Popular Investment Destinations as a Percentage of GDP, Log-Scale (IMF, 2013)



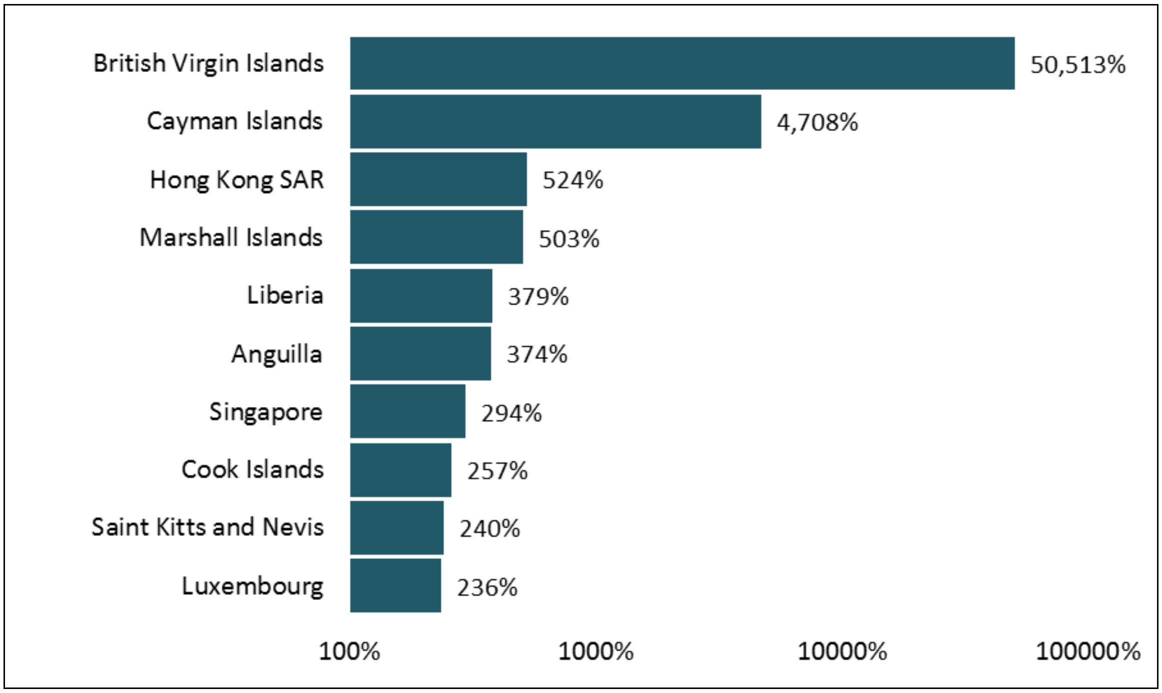
Source: CRS Analysis of IMF, World Economic Outlook Database, April 2014.

Notes: The data are graphed on a log-scale to accommodate the large range of values in a single graph. FDI data for Ireland and Malta are from 2012, as the data for 2013 were missing for these two countries.

The stock of FDI in the economies displayed in **Figure 7** is still notable without adjusting for countries' size. The Netherlands, for example, has a larger absolute inward FDI position ($4.3 trillion) than the largest economy in the world, the United States ($2.8 trillion). Luxembourg follows close behind with a $3.3 trillion inward FDI position. Combined, the Netherlands and Luxembourg account for 27% of worldwide inward FDI positions, which is more than the two largest economies in the world—the United States and China—which account for 18% combined.

The United Nations (U.N.) compiles data similar to the IMF. While differences in methodology, measurement issues, and countries covered by each group lead to discrepancies between the two datasets, both paint the same general picture; there is a disproportionate amount of FDI being reported in tax-haven and tax-preferred countries. **Figure 8** displays the 10 countries with the highest inward FDI postion to GDP ratios as reported by the U.N. in 2013. The British Virgin Islands has the largest inward FDI position, equal to 50,513% of GDP, followed by the Cayman Islands (4,708%), Hong Kong (524%), and the Marshall Islands (503%).

Figure 8. Inward FDI Position in10 Most Popular Investment Destinations as a Percentage of GDP, Log-Scale (U.N., 2013)



Source: CRS analysis of United Nations Conference on Trade and Development Statistics.

Notes: The data are graphed on a log-scale to accommodate the large range of values in a single graph. GDP figure for British Virgin Islands is from 2012.

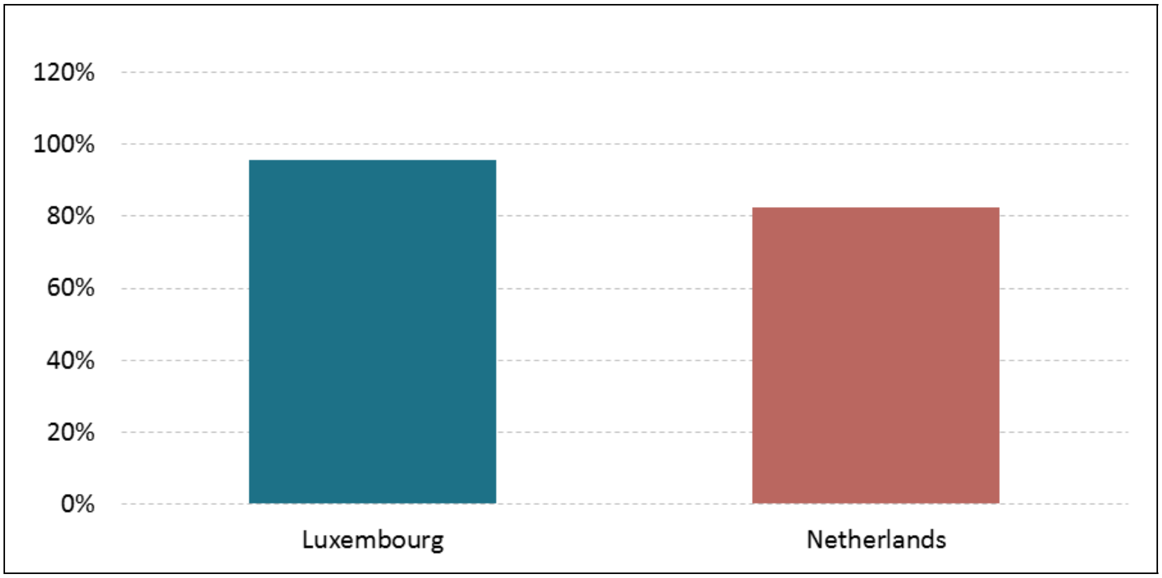
A final indication that profit shifting may be occuring can be found by looking at how much investment is funneled through special purpose entities (SPEs). According to the OECD,

> Examples [of SPEs] are financing subsidiaries, conduits, holding companies, shell companies, shelf companies and brass-plate companies. Although there is no universal definition of SPEs, they do share a number of features. They are all legal entities that have little or no employment, or operations, or physical presence in the jurisdiction in which they are created by their parent enterprises which are typically located in other jurisdictions (economies). They are often used as devices to raise capital or to hold assets and liabilities and usually do not undertake significant production.[26]

Data on the use of SPEs are scarce. The OECD, however, does publish data on the inward FDI positions of the Netherlands and Luxembourg that are broken down into investment held through SPEs and non-SPEs. In 2013, the total inward FDI stock held via SPEs in Luxembourg and the Netherlands was $3.1 trillion and $3.9 trillion, respectively, both of which are larger than the total inward FDI stock of the United States. As **Figure 9** shows, 83% ($3.2 trillion) of the inward FDI position in the Netherlands is held through SPEs. For Luxembourg the share is even higher; 96% of its inward FDI position is held through SPEs.

[26] OECD, *Addressing Base Erosion and Profit Shifting*, 2013, p. 22, http://dx.doi.org/10.1787/9789264192744-en.

Figure 9. Share of Total Inward FDI Position Held Through Special Purpose Entities, (2013)



Source: CRS analysis of OECD Foreign Direct Investment (FDI) Statistics, FDI series from 1990 to Q4 2013.

Policy Options and Considerations For Reducing Profit Shifting

The debate over reducing profit shifting and reforming the international tax system may involve a number of policy considerations and tradeoffs. Proposals thus far have included moving closer toward a pure-form worldwide system, moving closer toward a pure-form territorial system, adopting a new approach such as a minimum tax or formula apportionment, or modifying the current system's rules and structure. There is also on the horizon the completion of OECD's Base Erosion and Profit Shifting (BEPS) initiative. The remainder of this report discusses these considerations generally. For more detailed information see CRS Report RL34115, *Reform of U.S. International Taxation: Alternatives*, by Jane G. Gravelle and CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle.

Worldwide vs. Territorial Taxation

There have been calls for the United States to change its approach to taxing American MNCs. The United States currently follows what roughly approximates the so-called "worldwide" approach to taxation. While the United States generally follows this approach, corporations are typically allowed to defer paying taxes on income earned abroad until that income is brought home, or repatriated, in the form of a dividend payment to the U.S. parent. Additionally, foreign taxes paid in one country may be used to offset income earned in other countries via a process known as cross-crediting. These two features—deferral and cross-crediting—result in the current system straying away from the worldwide approach and into a hybrid system with both worldwide and territorial system features. Where exactly on the spectrum between worldwide and territorial taxation the current system lies is not precisely known. The general implications of moving closer toward either system are discussed below.

Move Closer Toward Worldwide Taxation

If the United States were to transition toward a more pure-form worldwide system, the most straightforward way to do this would be to eliminate deferral while still allowing a credit for foreign taxes paid. Such an approach would result in U.S. investments being taxed at the same total tax rate (foreign plus U.S.), regardless of where investments were made.[27] As a result, investment decisions would be made based on real economic returns and not on any differential between U.S. and foreign tax rates. This, in turn, would lead U.S. corporations to allocate capital to its most productive use in the world economy. Additionally, corporations would largely have no incentive to shift profits or to accumulate large sums of cash overseas (like the current system incentivizes firms to do) because all earnings would be taxed currently.

A reduction in the incentive to shift profits as the result of a purer-form worldwide system would also likely reduce complexity in the administration of the tax system because many tax strategies would be rendered useless. A pure-form-type system would still likely require that income and costs be allocated between domestic and foreign activities for purposes of the foreign tax credit. If the movement to a more worldwide system was accompanied by a per-country foreign tax credit limit (to eliminate cross-crediting), however, then U.S. corporations would have to allocate income and expenses between domestic and foreign activities *and* allocate income and expenses between affiliated foreign subsidiaries. To the extent that firms were in an excess credit position (had credits they could not use because of the foreign tax credit limit), there would be an incentive to shift profits to lower-tax countries. Without the ability to defer income, however, excess credits would likely be reduced.

There are concerns over moving toward a more pure-form worldwide tax system. Without the proper safeguards in place, it is likely that a true worldwide tax system would encourage corporations to shed their U.S. corporate charter by reincorporating abroad via a process known as “inversion.” Several high profile U.S. companies expressed interest in inverting under the current hybrid system in early and mid-2014. In response, Treasury released a notice of regulatory changes that would further restrict the ability to invert and has indicated that additional actions are possible. Legislation was also introduced in Congress that would modify current laws meant to curb the practice, although nothing was enacted.[28] The recent regulatory changes and proposed legislative changes would likely need to be strengthened to prevent inversions under a pure worldwide system.[29] For more detailed information on corporate inversions see CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.

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[27] To see this, consider a U.S. firm that must allocate investment between two locations. The first location, Country A, has a 15% tax rate, while the second location, Country B, has a 30% tax rate. Under a pure worldwide system, income earned in Country A would be subject to a 15% foreign tax, and then a residual 20% U.S. tax after claiming a credit for foreign taxes paid. The result is a total (foreign plus U.S.) tax of 35%. Income earned in Country B would be subject to a 20% foreign tax, and then a residual 15% U.S. tax also resulting in a total tax of 35%. Thus, under a pure worldwide system, the total tax rate in both countries is the same, and taxes have no effect on investment decisions.

[28] For more information on corporate inversions, including legislative proposals, see CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.

[29] A detailed discussion about this subject is beyond the scope of this report and can involve intricate legal technicalities. For an introduction to this issue, see CRS Report R43568, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, by Donald J. Marples and Jane G. Gravelle.

Concern has also been expressed that moving from the current hybrid system to a true worldwide system would reduce America's international competitive position. Using "competition" as an evaluation criterion is problematic because generally it is not well defined in the context of international tax policy, and often times the "competitive" concepts that are used are at odds with each other.[30] For example, does increasing America's competitive position call for tax policies that promote the flow of U.S. capital (and therefore business operations and jobs) abroad to better compete in international markets? Or does it call for policies that reduce the flow of capital (and therefore business operations and jobs) abroad so that it remains in the United States and can be put to use domestically? There is an argument that these two objectives are not at odds with each other, and that promoting increased foreign investment and employment complements increased domestic investment and employment.[31] There is not conclusive evidence to support this argument.

Additionally, it is important to understand that countries do not compete with each other in an economic sense. Competition implies a zero-sum game with winners and losers. But enhanced economic well-being in one country generally does not reduce economic opportunities in other countries. Instead, countries *trade* with each other. 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. Greater production leads to more product variety, lower consumer prices, and greater average incomes.[32] For these reasons, economists typically question whether "competitiveness" makes sense as a tax policy objective for a country. For economists, the typical objective is economic efficiency, or the optimal allocation of limited resources.

Move Closer Toward Territorial Taxation

If the United States were to transition toward a more pure-form of a territorial system it would forgo taxing income earned outside its borders. This change would result in U.S. investments being taxed at the rates that exist where the investments are made. As a result, investment decisions would no longer be based solely on real economic returns, but on after-tax returns that would vary country by country. This variation, in turn, would lead U.S. corporations to allocate more investment to lower-tax countries than they otherwise would. Another feature of a territorial-based system would be that tax policy would no longer affect corporations' decisions to repatriate income because there would be no tax consequence for doing so. Recall that a pure worldwide system would also remove the influence of taxes on the repatriation decision, but in that case, it would be because taxes were unavoidable and not because repatriation would be tax-free.

It is argued that relative to the current hybrid system, a more territorial system would enhance the competitiveness of U.S. firms relative to their foreign competitors. Again, however, economists are typically skeptical of using competition criteria when evaluating international tax policy, whether it is comparing a territorial system with the current system or with a true worldwide

[30] For a more in-depth discussion of this issue, see Jane G. Gravelle, "Does the Concept of Competitiveness Have Meaning in Formulating Corporate Tax Policy?" *Tax Law Review*, vol. 65 (2012), pp. 326-337.

[31] Mihir A. Desai, Fritz Foley, and James R. Hines, "Domestic Effects of the Foreign Activities of US Multinationals," *American Economic Journal: Economic Policy*, vol. 1, no. 1 (February 2009), pp. 181-203.

[32] British economist David Ricardo first formalized the idea of comparative advantage in his 1817 book titled *On the Principles of Political Economy and Taxation*.

system. Still, the effective U.S. tax burden on foreign earned income is already argued by some analysts to be quite low because of the ability to shift income to low-tax countries, suggesting that the current system may not be inhibiting the overseas operations of American MNCs.[33]

A territorial system raises some of the same concerns that the current system does regarding profit shifting. Specifically, profit shifting could increase under a territorial system without the proper anti-abuse provisions in place. With a territorial system, income earned abroad would be exempt from U.S. tax. MNCs would therefore have an incentive to attribute as much income as possible to operations outside the United States. Anti-abuse provisions particularly focused on the transfer of intangible assets (patents, intellectual property, etc.) out of the United States may be the most useful at curbing profit shifting under a territorial system. For a detailed discussion about profit shifting under a territorial system, see CRS Report R42624, *Moving to a Territorial Income Tax: Options and Challenges*, by Jane G. Gravelle.

Does the Distinction Matter?

There is the issue of whether the distinction between worldwide and territorial systems is even relevant for current policy debates.[34] Among the major economies, no country has either a pure worldwide or territorial system—they are all hybrid systems. The problem then becomes one of degree and depends on the specific differences in each country's international tax regime. For example, a country typically classified as having a worldwide-based system could actually tax foreign source income at a lower effective rate than a country that is typically classified as having a territorial system. One possible way this could arise is if the worldwide-based country allows deferral for most types of income, and the territorial-based country has in place effective base erosion provisions. Which system is preferable in this situation is not clear.

Problems can also arise when attempting to empirically analyze or compare worldwide and territorial systems as two distinct country groups. Labeling a system as worldwide or territorial without considering where on the "spectrum" it lies is too simplistic and can lead to mislabeling. This mislabeling, in turn, can lead to questionable empirical results when comparing groups of countries labeled as "worldwide" and "territorial" because the countries within the groups are themselves quite heterogeneous. It may be better to stick to pairwise comparison so that the nuances of the two systems can be better accounted for.

Adopt a Minimum Tax

A worldwide minimum tax could potentially allow for some balance to be struck between multinational corporations' concerns over tax burdens and governments' concerns over profit shifting.[35] With a minimum tax, income earned in countries with a tax rate below a specified threshold would be subject to immediate U.S. taxation at the threshold tax rate. Income earned in countries with a tax rate above the threshold would be exempt from U.S. tax or eligible for

[33] Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," *Tax Notes*, September 5, 2011, pp. 1021-1042.

[34] The discussion here is based on Kimberly A. Clausing, "Beyond Territorial and Worldwide Systems of International Taxation," *Working Paper*, February 2015, http://ssrn.com/abstract=2567952.

[35] See, for example, Rosanne Altshuler and Harry Grubert, "Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax," *National Tax Journal*, vol. 66, no. 3 (September 2013), pp. 671-712.

deferral. Typically, a credit would be allowed for foreign taxes paid, but the credit would be calculated on a country-by-country basis to prevent cross-crediting.

An example may be useful. Say that the United States set a minimum tax threshold of 20% of net income. If a corporation where to report $100 million of income as being earned in a country with a tax rate of 15%, the corporation would then be subject to a 20% U.S. tax in the year the income was earned. However, the United States would credit the corporation for the 15% in taxes paid abroad, leaving the company with a residual U.S. tax of 5%. The foreign tax credit prevents double taxation of income and also ensures that the firm's total tax rate is no greater than 20% (15% to the foreign country plus 5% to the United States). The minimum tax could also apply only to particular types of income, such as passive income or income associated with intellectual property.

Several proposals to install a minimum tax have been offered in recent years. In the 112th Congress, Senator Enzi introduced S. 2091, which would have enacted a minimum tax equal to half the top U.S. corporate rate, but would have exempted active business income. Former Senate Finance Committee Chairman Max Baucus's tax reform discussion draft, published in November 2013, also included several options for imposing a minimum tax.[36] Senator Baucus never introduced formal legislative language so it is not clear exactly how the tax would have been structured, or to what income it would have applied. Former Ways and Means Chairman Dave Camp's Tax Reform Act of 2014 (H.R. 1) included a minimum tax that ranged from between 12.5% to 25% depending on the type of income.[37] Most recently, the President's FY2016 budget includes a proposed 19% minimum tax on American corporations' overseas income.[38]

The minimum tax approach could have some undesirable features depending on its design.[39] If the minimum tax only applied to low-tax-rate countries it could still leave an incentive to shift profits to countries with a tax rate just above the minimum tax. For example, if the minimum tax only applied to countries with a tax rate of 10% or lower, profits could still be shifted to Ireland which has a 12.5% tax rate without triggering the tax. This problem could be avoided or at least mitigated by setting the minimum tax rate appropriately high enough (for example, at the average of the countries not considered tax havens). The problem would also be avoided by imposing an overall minimum worldwide tax with a credit for taxes paid.

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[36] For more information on Senator Baucus's international tax reform discussion draft, see http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14. United States Senate Committee on Finance, "Baucus Unveils Proposal for International Tax Reform," press release, November 19, 2013, http://www.finance.senate.gov/newsroom/chairman/release/?id=f946a9f3-d296-42ad-bae4-bcf451b34b14.

[37] The specific minimum tax rates proposed were 12.5% on foreign base company sales income, 15% on foreign base company intangible income, and 25% on foreign base company income. For a summary of the relevant international tax provisions contained in H.R. 1, see U.S. Congress, Joint Committee on Taxation, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of The Chairman of The House Committee on Ways and Means to Reform The Internal Revenue Code: Title IV—Participation Exemption System for the Taxation of Foreign Income*, 113th Cong., 2nd sess., February 26, 2014, JCX-15-14.

[38] For more information on the President's budget, see Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals*, February 2015, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf.

[39] A number of these concerns are expressed in Julie Martin "Minimum Tax on Multinationals Could Slow Profit Shifting," *Tax Notes*, March 19, 2012.

Second, there is concern that designing a minimum tax may be too complex.[40] For example, would it be each country's statutory tax rate or each company's effective tax rate that would be subject to the minimum threshold? If it were the latter, how would scenarios involving companies in a relatively high-tax country that experiences large losses in a year (lowering their effective tax rate) be handled? And third, concern has been expressed that a minimum tax is really a patchwork structure that is not consistent with either a territorial or worldwide system. The same argument, however, can be made about the current U.S. international tax system.

Adopt Formula Apportionment

Another option that has been suggested that could reduce profit shifting is the adoption of a formula apportionment approach to taxation. The current system requires U.S. corporations to price transactions between affiliated companies to determine the allocation of income and expenses. This provides an opportunity to shift profits to low-tax countries. An alternative would be to pool profits earned around the world and then allow countries to tax a share of the total profits, eliminating the need for transfer pricing. The share each country could tax would be determined by a formula that measures real business activity conducted in each country.

To understand how formula apportionment works, it may help to consider an example of a sales-based approach. Under this method, if a U.S. company earned $100 million of profits worldwide and 60% of its sales occurred domestically, then the United States would have the right to tax $60 million ($100 million multiplied by 60%). The remaining $40 million could be subject to taxation in the jurisdictions where the 40% of foreign sales occurred. More realistically, the formula used to apportion profits might depend on more than just sales, such as the location of assets and employees. In this case, known as a multi-factor formula, taxable profits would be determined by the weighted average of factor activity occurring in each country. For example, if a company had 60% of its sales, 30% of its assets, and 25% of its employees in the United States, then the share of income that would be taxable in the United States would be $100 million multiplied by (0.6+0.3+0.25)/3, or $38.3 million.[41]

There is currently a debate among economists over desirability of switching to a formula apportionment regime and its ability to reduce profit shifting.[42] If the apportionment formula can be easily manipulated then its impact on profit shifting may be limited. It has been argued that a sales-based formula would be less susceptible to manipulation. At the same time, it has been

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40 This concern has been expressed by Ed Kleinbard, Professor of Law, University of Southern California Gould School of Law. Reported in Julie Martin, "Minimum Tax on Multinationals Could Slow Profit Shifting," *Tax Notes,* March 19, 2012.

41 This is an example of an equal-weighted multi-factor formula. A more complex formula would give different weights to each factor.

42 For a sample of the ongoing debate in the literature, see Reuven S. Avi-Yonah and Kimberly A. Clausing, *Reforming Corporate Taxation in a Global Economy: A proposal to Adopt Formulary Apportionment*, Hamilton Project Discussion Paper, Brookings Institution, June 2007, http://www.brookings.edu/~/media/research/files/papers/2007/6/corporatetaxes-clausing/200706clausing_aviyonah.pdf; Rosanne Altshuler and Harry Grubert, "Formula Apportionment: Is it better than the current system and are there better alternatives?" *National Tax Journal* , vol. 63, no. 4 (December 2010), pp. 1145-1184; Kimberly A. Clausing, *Lessons for International Tax Reform from the U.S. State Experience under Formulary Apportionment*, Working Paper, June 29, 2014, http://ssrn.com/abstract=2359724; and J. Clifton Fleming Jr., Robert J. Peroni, and Stephen E. Shay, "Formulary Appointment in the U.S. International Income Tax System: Putting Lipstick on a Pig?," *Michigan Journal of International Law*, vol. 36, no. 1 (Fall 2014), pp. 1-57.

argued that without extensive recordkeeping or a tracking system, nothing would stop an MNC from setting up a chain of subsidiaries in low-tax countries to which intermediate components are sold on their way to their final destination, which could be a high-tax country. Determining how those intermediate sales are to be treated in the allocation formula could be difficult, or at least increase the administrative complexity of the approach. Alternatively, a U.S. MNC could enter into a sales contract with an unrelated foreign distributer who is based in a low-tax country. Again, the sales to the distributer would seem to dictate that the MNC's profits should be allocated to the low-tax location of its distributer. There has been, however, legislative and regulatory language proposed by at least one tax practitioner that is aimed at addressing these concerns.[43]

The increasing role of intangible assets (patents, trademarks, copyrights, etc.) may also limit a formula apportionment regime's capacity to reduce profit shifting. For example, a sales-based approach would generally result in some share of taxable income being apportioned to foreign locations when that income arguably should be taxable in the United States since that is where the initial R&D investment was made. Additionally, to the extent that the investment was subsidized by the U.S. government via the tax code or federal funding (e.g., NSF grants, SBA loans, etc.) it could be argued that the associated income should be taxable in the United States. A multi-factor formula that incorporated assets may not fare much better given the difficulty of valuing intangible assets. Still, formula apportionment may result in more income being subject to tax in more jurisdictions than currently occurs.

Formula apportionment may also require international cooperation. It is possible that if countries unilaterally establish a formula-apportionment-type system that some income could either face no taxation or double taxation. The reason for this is differences in tax systems and taxable bases across countries. Harmonizing tax systems so that they mirrored each other as closely as possible would likely mitigate the risk of lapses or redundancies in the worldwide tax system.

Modify Subpart F Rules

In contrast to a minimum tax, which targets the income earned in particular low-tax countries, Congress could target the types of income firms use to shift money to tax havens. This was the intent of the Subpart F rules that were enacted to prevent deferral of highly fungible income that can be more easily shifted.[44] Since 1997, however, there has existed a temporary "active financing income" exception to the Subpart F rules.[45] The active financing exception allows deferral for certain types of passive income earned by American corporations that operate banking, financing, and insurance lines of business abroad, even if their primary line of business is quite different. On the one hand, there is the argument that there are real economic reasons for keeping this income abroad and that transactions involving active financing income are not necessarily for tax avoidance purposes. On the other hand, it could be argued that passive income

[43] See Michael Durst, "Analysis of a Formulary System, Part VIII: Suggested Statutory, Regulatory Language for Implementing Formulary Apportionment," *Tax Management Transfer Pricing Report,*, vol. 23, no. 1 (May 1, 2014).

[44] U.S. Department of the Treasury, Office of Tax Policy, *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, December 2000, pp. 1-22, http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf.

[45] The exception has been extended a number of times for various lengths since the most recent version of the provision was enacted by the by the Taxpayer Relief Act of 1997 (P.L. 105-34). The most recent extension was enacted as part of the "extenders package" in P.L. 113-295.

is passive income, regardless of the underlying line of business. Nonetheless, active financing income earned through the end of 2014 qualified for deferral and in recent years has only been taxed when it is repatriated to the United States. Congress could choose to modify the active financing exception if it were to extend the provision again for 2015, or allow it to remain expired if Congress believes the exception is used more to avoid taxes than to finance real operations.

Another option would be to expand the definition of Subpart F income. For example, the President's FY2015 and FY2016 budgets both included an expanded definition of Subpart F income that would include "foreign base company digital income," or income derived from selling or licensing digital products and services.[46] Expanding the definition of Subpart F income to encompass more income related to intangible assets may help curb profit shifting; a significant share of profit shifting is believed to be associated with intangible assets.

Reduce Corporate Tax Rates

One topic that has been part of nearly every debate regarding corporate tax reform has been the 35% top statutory corporate tax rate. Reducing this rate would decrease the incentive to shift profits by reducing the tax savings from such behavior. Companies profit shift to take advantage of the differential between the U.S. tax rate and rates in low-tax countries. By reducing this discrepancy, the incentive to shift profits would be reduced as well. Note, however, that reducing the U.S. tax rate to within the range typically suggested, 25% to 28%, would still leave the United States as a high-tax country relative to tax havens, implying that the incentive to profit shift would remain. A reduction in the top tax rate may also reduce federal revenue because of lower tax rates being applied to corporate net income.[47] Combining a rate reduction with a broadening of the corporate tax base and strong anti-base erosion provisions would help to offset any revenue loss.[48]

The OECD's BEPS Project

At the request of the G20 finance ministers, the OECD has initiated the development of an Action Plan on Base Erosion and Profit Shifting. The goal is to develop 15 detailed actions governments can take that will reduce *double non-taxation* of corporate and individual income—a situation where profit shifting gives rise to so-called "stateless" or "homeless" income—and prevent the *double taxation* of income. If successful, the Action Plan should also lead to a more coherent and transparent international tax system. Some of the actions will require coordination and information sharing between governments, and potentially the amendment of over 3,000 existing tax treaties.[49] As a result, success of the Action Plan will likely depend on widespread participation by G-20 and OECD member countries as well as nonmember countries.

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46 Office of Management and Budget, *The President's Budget for Fiscal Year 2016*, February 2, 2015, https://www.whitehouse.gov/omb/budget, and Office of Management and Budget, *The President's Budget for Fiscal Year 2015*, March 4, 2014, https://www.whitehouse.gov/omb/budget,

47 For detailed discussions of the revenue consequences of lowering the corporate rate and for reviews of the literature, see CRS Report RL34229, *Corporate Tax Reform: Issues for Congress*, by Jane G. Gravelle; and CRS Report R40623, *Tax Havens: International Tax Avoidance and Evasion*, by Jane G. Gravelle.

48 For more information, see CRS Report R41743, *International Corporate Tax Rate Comparisons and Policy Implications*, by Jane G. Gravelle.

49 Organisation for Economic Co-operation and Development, *OECD Secretary-General Report to the G20 Finance* (continued...)

The OECD set three deadlines for producing "deliverables" consisting initially of reports and draft rules, and culminating with the finalized 15-point Action Plan. The first set of deliverables was presented to and endorsed by the G20 finance ministers on time in September 2014. It was later endorsed by the G20 heads of government at the Brisbane Summit in November 2014. The second set of deliverables is scheduled for September 2015, and the third set of deliverables, which will include the final Action Plan, is scheduled for December 2015. **Appendix A** provides more details on the Action Plan and its current status.[50]

The OECD has been careful to stress that many of the strategies used by multinational corporations are likely legal.[51] The Director of the OECD's Centre for Tax Policy and Administration, Pascal Saint-Amans, said in a 2013 interview, "What we say at the OECD, [is] that we shouldn't put the blame on the business. The business and the companies are doing their job, which is to plan their taxes, to do aggressive tax planning. It can be more or less aggressive, sometimes it's too aggressive, but basically this is legal."[52] Thus, for the most part, the BEPS project does not appear to be driven primarily by concerns over the legality of corporate tax planning.

Instead, the OECD has argued that BEPS is important for three other reasons.[53] First, the ability of multinational corporations to artificially lower their taxes gives them a competitive advantage over companies that primarily operate in their home market. Second, profit shifting and base erosion distort investment by altering the relative rates of return across locations. An efficient tax system would direct capital to locations based on real economic returns. Instead, profit shifting can result in more capital investment in jurisdictions with a lower economic return but a higher after-tax return because of tax differentials. And third, the OECD argues BEPS is important based on fairness concerns. If multinational corporations have the means to avoid or reduce taxes, and other taxpayers (including individuals) do not, then it may create the perception that the tax system is unfair. Furthermore, tax avoidance by some may encourage tax avoidance by others.

There are a number of reasons why Congress may want to consider the implication of the BEPS Action Plan even though it is still being formalized. The objective of the OECD's project is to build consensus among countries on a more coherent and transparent international tax system. So far, the Treasury Department has been the primary representative of the United States in BEPS-related negotiations and meetings, although the business community has also been actively involved in providing feedback on proposed rules. In the end, however, several of the proposed

(...continued)

Ministers and Central Bank Governors, Istanbul, Turkey, February 2015, p. 3, http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-february-2015.pdf.

[50] This list is based on the summaries provided by the OECD found here: http://www.oecd.org/tax/beps-about.htm and http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm.

[51] In its BEPS FAQ, it includes the following question and response: "48. Are BEPS strategies illegal? Although some schemes used are illegal, most are not. Largely they just take advantage of current rules that are still grounded in a bricks and mortar economic environment rather than today's environment of global players which is characterized by the increasing importance of intangibles and risk management." OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Frequently Asked Questions*, undated, http://www.oecd.org/ctp/beps-frequently-asked-questions.pdf.

[52] "Pascal Saint-Amans, OECD Tax Policy Head, On Global Tax System Reform, YouTube video, posted by "INSEAD," August 19, 2013, https://www.youtube.com/watch?v=c4effB4i4jk&feature=youtu.be

[53] See question 50 in, OECD, *OECD/G20 Base Erosion and Profit Shifting Project: Frequently Asked Questions*, undated, http://www.oecd.org/ctp/beps-frequently-asked-questions.pdf.

actions may require modification of existing tax treaties.[54] The Senate would need to ratify any tax treaty modifications. Treaty modification and negotiations under the Action Plan framework may suggest a multilateral approach which is different than the bilateral approach the United States traditionally has followed for tax treaties. It is unclear at this point if particular tax laws would be subject to change too. Harmonization of tax bases and anti-abuse policies could potentially call for modification to the IRC, which would require congressional approval.

Additionally, even if the U.S. does not implement any of the proposed actions, U.S. multinationals will likely still be impacted.[55] For example, some countries have already taken unilateral actions to preserve their tax bases and there is concern more may follow, which could impact U.S. multinationals.[56] While unilateral action may sound encouraging, it runs contrary to the OECD's goal of creating a coordinated, multilaterial, and transpartent international tax regime. The U.K.'s diverted profits tax proposal has been identified as one such example. The tax, which went into effect on April 1, 2015, subjects income deemed to have been artificially shifted out of the U.K. to a 25% tax. The tax is aimed at curbing profit shifting by MNCs, particularly American MNCs with U.K. operations, with the tax being referred to by some as the "Google tax."[57]

Once the Action Plan is finalized and adopted, American MNCs could also be subject to some of its base erosion rules even if the U.S. does not adopt the rules. For example, a country that adopts the BEPS country-by-country reporting standards could require U.S. companies to report detailed operating information for each country they operate in to that country's tax authority so that the tax authority can determine whether their domestic tax base is being eroded by profit shifting. It has been pointed out by practioners that this in turn, could result in non-adopting countries (including the U.S.) requesting such information for their own purposes (since they know the firm has already had to compile it). Likewise, if other countries adopt the OECD's suggestions for targeting hybrid mistmatch arrangements, or the taxation of income associated with intangible assets, American multinationals may find it more difficult to shift profits regardless if the U.S. adopts such recommendations.[58]

Lastly, concerns exist over the OECD's approach. For example, some commentators have raised the posibility that in an attempt to reduce BEPS, the OECD's efforts may end up stifling trade and international investment.[59] To the extent this happens, the extra revenue governments collect as the result of reduced profit shifting may not be enough to compensate for the decline in economic activity.

[54] For a list of current treaties see, Internal Revenue Service, *United States Income Tax Treaties—A to Z*, http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties—A-to-Z.

[55] Clark Chandler, Stephen Blough, and Michael Plowgian, "Why U.S. Multinationals Need to Care About BEPS Even if the U.S. Doesn't Change Anything," *Daily Tax Report*, September 15, 2014.

[56] See, for example, Amanda Athanasiou, "Jumping the Gate on BEPS Unilateral Actions," *Tax Notes International*, March 16, 2015, pp. 937-939.

[57] See, for example, Vanessa Houlder, "'Hard core' tax dodgers to face strong crackdown," *Financial Times*, March 14, 2015, online edition, http://www.ft.com/intl/cms/s/0/c745a21e-c8c9-11e4-8617-00144feab7de.html#axzz3UkUZrR4q.

[58] Both of these issues were raised in Clark Chandler, Stephen Blough, and Michael Plowgian, "Why U.S. Multinationals Need to Care About BEPS Even if the U.S. Doesn't Change Anything," *Daily Tax Report,* September 15, 2014.

[59] See, for example, Amanda Athanasiou, "The Cost of BEPS: A Question of Balance," *Tax Notes International*, January 19, 2015, pp. 195-197.

Appendix A. OECD'S BEPS Action Plan Status

The OECD set three deadlines for producing "deliverables" leading to the finalized proposed Action Plan: September 2014, September 2015 and December 2015. The first set of deliverables was presented to and endorsed by the G20 Finance Ministers on time in September 2014. They were later endorsed by the G20 heads of government at the Brisbane Summit in November 2014. The first set of deliverables was comprised of the following items:[60]

1. A report identifying tax challenges raised by the digital economy and the necessary actions to address them (Action 1)
2. Recommended rules for dealing with hybrid mismatch arrangements (Action 2)
3. A report reviewing member country regimes in order to counter harmful tax practices by increasing transparency (Action 5)
4. Recommended rules regarding the design of domestic and tax treaty measures to prevent abuse of tax treaties (Action 6)
5. Recommended rules for transfer pricing involving intangibles (Action 8)
6. Recommended rules for transfer pricing in relation to country-by-country documentation requirements (Action 13)
7. A report on the development of a multilateral, as opposed to a bilateral, mechanism to implement BEPS measures, particularly with regard to treaty modification (Action 15)

According to the OECD, the following deliverables (as well as the completed Action Plan) are on schedule. The remaining deliverables include the following:

September 2015

8. Recommendations regarding the design of domestic rules to strengthen Controlled Foreign Companies (CFC) Rules (Action 3)
9. Recommendations regarding the design of domestic rules to limit base erosion via interest deductions and other financial payments (Action 4)
10. Strategy to expand participation to non-OECD members to counter harmful tax practices more effectively (Action 5)
11. Tax treaty measures to prevent the artificial avoidance of permanent establishment status (Action 7)
12. Changes to the transfer pricing rules in relation to risks and capital, and other high-risk transactions (Actions 9 and 10)
13. Recommendations regarding data on BEPS to be collected and methodologies to analyze them (Action 11)

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[60] This list is based on, and includes, the summaries provided by the OECD found here: "About BEPS," Organisation for Economic Co-operation and Development, http://www.oecd.org/tax/beps-about.htm; and "BEPS–Frequently Asked Questions," Organisation for Economic Co-operation and Development, http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm.

14. Recommendations regarding the design of domestic rules to require taxpayers to disclose their aggressive tax planning arrangements (Action 12)
15. Tax treaty measures to make dispute resolution mechanisms more effective (Action 14)

December 2015

16. Changes to the transfer pricing rules to limit base erosion via interest deductions and other financial payments (Action 4)
17. Revision of existing criteria to counter harmful tax practices more effectively (Action 5)
18. The development of a multilateral instrument (Action 15)
19. Completion of the full 15 item Action Plan

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