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International Tax Rules

Key Points:

- Companies often earn profits through foreign subsidiaries and send a portion of those profits to the domestic headquarters.
- International tax rules and tax treaties are tools that countries use to tax multinational businesses.
- The U.S. recently updated its rules that define income and minimize tax avoidance in the Tax Cuts and Jobs Act.
- Businesses respond to these rules when constructing their supply chains and making investment and hiring decisions both overseas and at home.

In 2018, two-thirds of employees for U.S. multinational companies were based in the U.S., representing 22 percent of the U.S. workforce.

When U.S. companies succeed abroad, it can mean more investment in domestic activities and more hiring at home. Research that compares multinational companies to purely domestic businesses has shown that multinationals are more productive and innovative.

Most OECD countries have developed international tax rules to determine the taxation of income companies earn from overseas operations and sales. Businesses design supply chains and make investment decisions based on economic factors but must consider these rules as well, especially when they have operations across the globe and send profits cross-border.

Countries usually design their tax rules so that profits are taxed once, rather than multiple times by multiple jurisdictions. In general, there are three tools that countries have to achieve this goal: tax treaties and withholding tax rates; rules that define what income will be taxed by the country where the headquarters is located; and rules mitigating tax avoidance.

The U.S. utilizes a combination of these three tools to tax profits earned overseas by companies in the U.S. Tax treaties are normally bilateral, sometimes multilateral, agreements that clarify which countries can tax what income and when. In the absence of these agreements, the U.S. withholds 30 percent of payments to foreign

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Editor, Rachel Shuster
Designer, Dan Carvajal

Tax Foundation
1325 G Street, NW, Suite 950
Washington, DC 20005

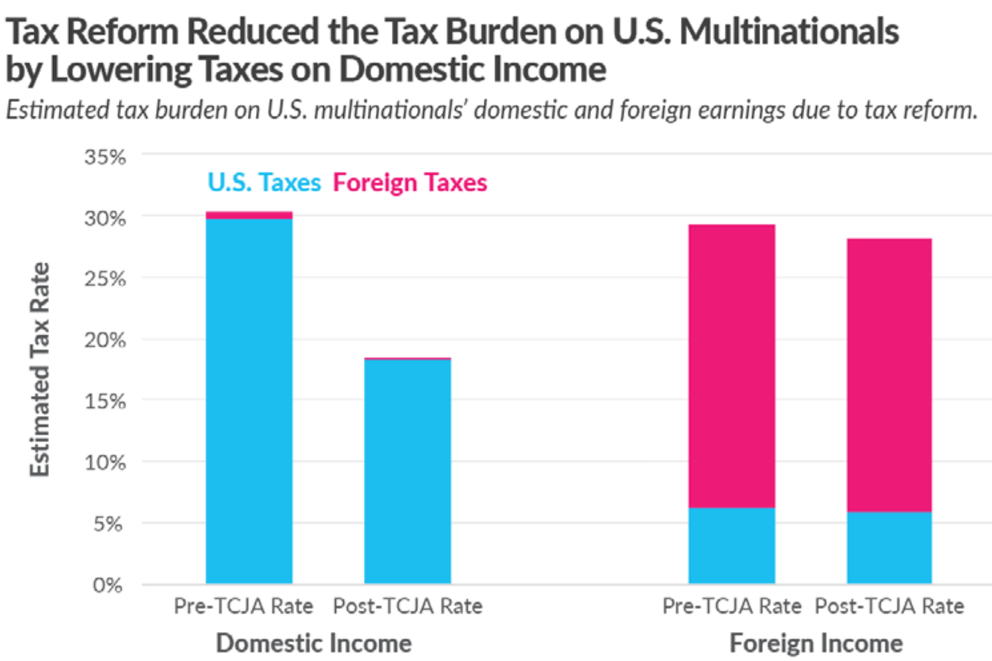
202.464.6200

taxfoundation.org

shareholders, regardless of the tax treatment in the foreign country. In 2019, the U.S. updated four bilateral tax treaties but other bilateral and multilateral agreements remain pending in the Senate.

The U.S. made significant revisions to its international tax rules, through the Tax Cuts and Jobs Act (TCJA), to create a territorial tax system that taxes income sourced to U.S. operations and sales. Provisions in the TCJA to further this goal include the participation exemption that allows companies to exclude or deduct foreign profits that they receive from foreign subsidiaries from domestic taxable income. Limits on interest deductions and controlled foreign corporation (CFC) rules also play a role in creating this system. Two TCJA provisions, the taxation of Global Intangible Low Tax Income (GILTI) and the Base Erosion and Anti-Abuse Tax (BEAT), serve as guardrails to prevent companies from shifting income to low tax jurisdictions.

While the TCJA reduced taxes for domestic earnings, the overall tax burden on foreign earnings was left roughly unchanged. However, the tax base on foreign earnings is much broader than before the TCJA, meaning that changes to international tax rules like GILTI and BEAT would result in large tax hikes for U.S. multinational companies.



Note: These are point estimates based on a model that uses data from 1,624 U.S. multinational companies. The reduction in taxes on foreign income is not statistically different from zero.

Source: Scott Dyreng et al., "The Effect of U.S. Tax Reform on the Tax Burdens of U.S. Domestic and Multinational Corporations," Table 6, SSRN Scholarly Paper Social Science Research Network, June 5, 2020.

Clear tax treaties and limited international tax rules provide certainty for companies and prevent double taxation of their income. While these tools can reduce tax avoidance, strict or complex rules can reduce investment and hiring by multinational companies abroad or at home.

Contact:

Tyler Parks, Government Affairs Associate, parks@taxfoundation.org, (202) 919-3644

Daniel Bunn, Vice President of Global Projects, dbunn@taxfoundation.org, (864) 399-0369