PRESENT LAW AND ECONOMIC BACKGROUND RELATING TO PHARMACEUTICAL MANUFACTURERS AND U.S. INTERNATIONAL TAX POLICY

Scheduled for a Public Hearing
Before the
SENATE COMMITTEE ON FINANCE
on May 11, 2023

Prepared by the Staff
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INTRODUCTION AND SUMMARY

The Senate Committee on Finance has scheduled a public hearing on May 11, 2023, titled "Cross-border Rx: Pharmaceutical Manufacturers and U.S. International Tax Policy." This document,[1] prepared by the staff of the Joint Committee on Taxation, describes legal and economic background on U.S. taxation of U.S. multinational corporations and their cross-border activities.

Part I includes a general overview of present law relating to U.S. corporate income taxation, with a focus on selected provisions relevant to U.S.-based pharmaceutical companies.

Part II provides a summary of select issues of U.S. taxation of cross-border activity. Subpart A describes select U.S. tax rules common to multinational corporations, subpart B is a general overview of select U.S. tax rules applicable to foreign activities of U.S. taxpayers, and subpart C provides a high-level overview of the latest status of the Organisation for Economic Cooperation and Development's two-pillar solution.

Part III provides an analysis of recent economic literature that addresses cross-border taxation.

Part IV analyzes data based on U.S. corporate tax filings from 2014 through 2020 to provide insight on trends in U.S. pharmaceutical foreign- and U.S.-source income and activities.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Economic Background Relating to Pharmaceutical Manufacturers and U.S. International Tax Policy* (JCX-8-23), May 9, 2023. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

I. GENERAL OVERVIEW OF U.S. CORPORATE INCOME TAX

Corporations organized under the laws of any of the 50 States or the District of Columbia generally are subject to the U.S. corporate income tax on their U.S.-source and certain foreign-source income.[2] Foreign corporations generally are subject to the U.S. corporate income tax only on income that is effectively connected with a U.S. trade or business.

A. Taxable Income

1. In general

The taxable income of a corporation generally is its gross income less allowable deductions, computed based on the corporation's methods of accounting. Large C corporations (*i.e.*, those with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that exceed $29 million (for 2023[3])) are generally required to use an accrual method of accounting.[4] Under the accrual method of accounting, items of income generally accrue when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy, but no later than the taxable year in which such income is included as revenue for financial reporting purposes.[5] Items of expense generally may not be deducted prior to when all the events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[6]

For businesses involving the sale of property to others (*e.g.*, drug manufacturers), gross income is total sales less the cost of goods sold, plus any income from investment and from incidental or outside sources.[7] Gross income is determined on an annual or taxable year basis with the amount of each item of gross income (*e.g.*, total sales) for the taxable year determined under the taxpayer's method of accounting for each item.[8] In determining gross income, the

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[2] Under subchapter S of the Internal Revenue Code of 1986, as amended (the "Code"), a small business corporation may elect not to be subject to the corporate income tax (*i.e.*, may make an "S corporation election"). If an S corporation election is made, the income of the corporation flows through to the shareholders and is taxable directly to them.

[3] Sec. 3.31 of Rev. Proc. 2022-38, 2022-45 I.R.B. 445.

[4] Sec. 448. Special methods of accounting that provide an exception to the all events test may apply (*e.g.*, special methods for long term contracts subject to section 460). Unless otherwise indicated, all section references are to the Code.

[5] Sec. 451.

[6] Sec. 461.

[7] Treas. Reg. sec. 1.61-3(a).

[8] See *Automobile Club of New York, Inc. v. Commissioner*, 32 T.C. 906, 914 (1959), *aff'd* 304 F.2d 781 (2nd Cir. 1962) ("…net income under the statute is computed on an annual basis, and…there is no necessary correlation in any given year between receipts and expenses. Expenses with respect to income not yet earned are

amount of total sales included as an item of gross income is determined in accordance with the taxpayer's method of accounting under the income recognition rules.[9]

2. Income recognition

An accrual method taxpayer generally includes sales, gross receipts, and other items of gross income that have been realized in income no later than the taxable year in which such income is included as revenue for book purposes. Advance payments received for the sale of goods, services, or certain other items of income may generally only be deferred using a one-year deferral method.[10] An advance payment generally occurs when a taxpayer receives payment before the taxpayer provides goods, services, or other items to its customer.

Reduction for cost of goods sold

As previously noted, for businesses involving the sale of property, in determining gross income for the taxable year, sales are reduced by cost of goods sold. The amount of cost of goods sold included as a subtraction from total sales is determined in accordance with the taxpayer's methods of accounting for items included in cost of goods sold.[11] An amount may not be taken into account in the computation of cost of goods sold, and thus reduce total sales, any earlier than the taxable year in which economic performance occurs with respect to such amount.[12] Once economic performance occurs, amounts may only be taken into account in the computation of cost of goods sold if they are not required to be capitalized and are not subject to any other provision of the Code that requires the deduction to be taken in a taxable year later than the year when economic performance occurs.

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deductible when paid or accrued; and conversely, income is reportable when received or accrued, notwithstanding that some, or even all, expenses allocable thereto have not yet been incurred"); and *Hagen Advertising Displays, Inc. v. Commissioner*, 47 T.C. 139 (1966), *aff'd* 407 F.2d 1105 (6th Cir. 1969) ("Nothing in [Treas. Reg. sec. 1.61-3(a)] suggests that an attempt must be made to match a particular purchase with a particular sale or a particular item in inventory").

[9] Sec. 451.

[10] Sec. 451(c); Treas. Reg. sec. 1.451-8(c).

[11] Treas. Reg. sec. 1.61-3(a). See, *e.g.*, secs 263A, 461(h), and 471. See also, *e.g.*, line 2 of Form 1120, Form 1120S, or Form 1065, as well as Form 1125-A. A taxpayer's gross profit is generally determined by subtracting returns and allowances and cost of goods sold from gross receipts or sales. See line 3 of Form 1120, Form 1120S, or Form 1065.

[12] Treas. Reg. secs. 1.61-3(a), 1.263A-1(c)(2)(ii), and 1.446-1(c)(1)(ii). For a liability that arises out of the provision of services or property to the taxpayer by another person, economic performance occurs as the other person provides such services, as the other person provides such property, or as the taxpayer uses such property. For a liability that requires the taxpayer to provide property to others, economic performance occurs as the taxpayer provides the property to the other person. Sec. 461(h)(2)(A) and (B). A liability includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. See Treas. Reg. secs. 1.446-1(c)(1)(ii)(B) and 1.461-4(c)(1).

Accounting for inventories

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[13] In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period.[14] Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.[15] Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the first-in, first-out ("FIFO") method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer,[16] and the last-in, first-out ("LIFO") method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.[17]

FIFO valuation methods

Treasury regulations provide that taxpayers that maintain inventories under section 471 may determine the value of ending inventory under the cost method or the lower-of-cost-or-market ("LCM") method.[18] Under the LCM method, the value of each article in ending inventory is written down if its market value is less than its cost.[19] Additionally, subnormal goods, defined as goods that are unsalable at normal prices or in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or similar causes, may be written down to bona fide net selling price, under either the cost or LCM method.[20]

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[13] Sec. 471(a); Treas. Reg. sec. 1.471-1. Taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $29 million (for 2023) are not required to account for inventories under section 471, but rather may either account for inventories as nonincidental materials and supplies or conform to their financial accounting treatment of inventories. See sec. 471(c).

[14] Treas. Rec. sec. 1.471-2(e).

[15] See, *e.g.*, Form 1125-A, Cost of Goods Sold.

[16] Treas. Rec. sec. 1.471-2(d).

[17] Sec. 472; Treas. Reg. secs. 1.472-1 to 1.472-8.

[18] Treas. Reg. sec. 1.471-2(c). See Treas. Reg. sec. 1.471-3 for the rules on valuing inventories under the cost method, and Treas. Reg. sec. 1.471-4 for the rules on valuing inventories under the LCM method. Taxpayers valuing their inventory under section 472 (using a LIFO method) must maintain such inventories at cost.

[19] Treas. Reg. sec. 1.471-4(c).

[20] Treas. Reg. sec. 1.471-2(c).

LIFO

Under the LIFO method, it is assumed that the last items entered into inventory are the first items sold.[21] Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[22] Compared to FIFO, LIFO produces net income that more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory generally is not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which the quantity of items sold exceeds purchases.[23]

Section 263A

Section 263A and the regulations thereunder require that direct costs and certain indirect costs incurred by the taxpayer (*i.e.*, costs for which economic performance has occurred) must be capitalized and included in the basis of property produced or acquired for resale by the taxpayer with the capitalized costs recovered by including such amounts in cost of goods sold when the underlying inventory or property is sold.[24] Capitalizable indirect costs include royalty payments incurred by reason of production or resale activities (commonly referred to as "sales-based royalties").[25] Sales-based royalties, which are common in the pharmaceutical industry, may either be (i) entirely allocated to property produced or acquired for resale by the taxpayer that has been sold (*i.e.*, deducted as cost of goods sold in the taxable year of sale), or (ii) allocated between cost of goods sold and ending inventory.[26]

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[21] Sec. 472(b).

[22] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year. See Sec. 472(b); Treas. Reg. sec. 1.472-1.

[23] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (an inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

[24] Sec. 263A; Treas. Reg. sec. 1.263A-1(c)(4).

[25] Treas. Reg. sec. 1.263A-1(e)(3)(ii)(U).

[26] Treas. Reg. sec. 1.263A-1(e)(3)(ii)(U)(2). See also Treas. Reg. sec. 1.263A-1(c)(5) and Rev. Proc. 2014-33, 2014-22 I.R.B. 1060.

3. Expense recognition

As noted above, items of expense generally may not be deducted by an accrual method taxpayer prior to when all the events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[27] Allowable deductions include ordinary and necessary business expenditures,[28] such as salaries, wages, contributions to qualified retirement plans and certain other employee benefit programs, repairs, bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense (subject to limitation), certain losses, selling expenses, and other expenses. In the event these deductions exceed gross income, a net operating loss ("NOL") deduction may be allowed in other years, as described below. Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for all or a portion of the amount of dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied).[29]

Expenditures that produce benefits in future taxable years for a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized[30] and recovered over time through depreciation, amortization, or depletion allowances.[31] In some instances, taxpayers can recover their costs more quickly than under the general rules. An additional first-year depreciation deduction is allowed equal to up to 100 percent of the adjusted basis of qualified property.[32]

Certain expenditures may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[33] certain meal and entertainment

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[27] Sec. 461.

[28] Sec. 162.

[29] Sec. 243.

[30] Sec. 263.

[31] See, *e.g.*, secs. 167, 168, 197, and 611.

[32] Sec. 168(k). The 100-percent allowance is subject to a phasedown in 2023 through 2026 (2024 through 2027 for certain longer-lived and transportation property). Sec. 168(k)(6).

[33] For example, the carrying costs of tax-exempt State and local obligations (see sec. 265) and the premiums on certain life insurance policies are not deductible (see sec. 264).

expenses,[34] certain qualified transportation fringe and commuter benefits,[35] certain highly compensated employee remuneration in excess of $1 million per year,[36] a portion of the interest on certain high-yield debt obligations that resemble equity,[37] as well as fines,[38] penalties,[39] bribes,[40] kickbacks,[41] illegal payments,[42] and settlements subject to nondisclosure agreements paid in connection with sexual harassment or abuse.[43]

<u>Certain allowable deductions commonly incurred in the pharmaceutical industry</u>

<u>Rebates and chargebacks</u>

In the United States, sales discounts for pharmaceuticals are generally issued to customers at the point-of-sale, through an intermediary wholesaler/distributor in the form of a chargeback, or in the form of rebates through contractual or legal agreements with the private and public sector (*e.g.*, Medicaid and Medicare Part D).[44] The liability to pay a chargeback or rebate is generally deductible when paid by the taxpayer to the wholesaler/distributor.[45] However, an accrual method taxpayer who has adopted the recurring item exception method of accounting for its chargeback or rebate liabilities may generally deduct such liabilities for which it has a fixed and determinable liability by the end of its taxable year (*i.e.*, the taxable year of the sale to the end customer) if it pays the wholesaler/distributor by the earlier of the date the it files a timely income tax return (including extensions) for such taxable year or the 15th day of the

[34] Generally, deductions are prohibited with respect to entertainment, amusement, or recreation. Sec. 274. In addition, a deduction for any expense for food or beverages is generally limited to 50 percent of the amount otherwise deductible. Sec. 274(n). There are exceptions to the general rule limiting deductions for food or beverage expenses to 50 percent of the otherwise deductible amount, including an exception for expenses for food or beverages provided by a restaurant and paid or incurred after 2020 and before 2023. Sec. 274(n)(2)(D).

[35] Employers are disallowed deductions for expenses associated with providing qualified transportation fringe benefits unless amounts are reported and properly included in employee compensation (see sec. 274(a)(4) and (e)(2)) and are disallowed deductions for other commuter benefits generally (see sec. 274(l)).

[36] Sec. 162(m).

[37] Sec. 162(e)(5).

[38] Sec. 162(f).

[39] *Ibid.*

[40] Sec. 162(c).

[41] *Ibid.*

[42] *Ibid.*

[43] Sec. 162(q).

[44] See Rev. Rul. 2008-26, 2008-21 I.R.B. 985; Field Attorney Advice (“FAA”) 20121602F (Apr. 20, 2012).

[45] See sec. 461; Treas. Reg. secs. 1.461-1 and 1.461-4(g)(3).

ninth calendar month following the close of such taxable year (*e.g.*, by September 15, 2023, for the 2022 calendar taxable year).[46]

Alternatively, Medicaid rebates paid to State agencies by pharmaceutical manufacturers under the Medicaid Rebate Program are generally treated as purchase price adjustments that are subtracted from gross receipts.[47] Medicaid rebates are made with the purpose of reaching an agreed-upon selling price for drugs that are negotiated before the sale takes place and is treated as an adjustment to the manufacturer's gross receipts. However, the Internal Revenue Service ("IRS") generally limits this treatment to Medicaid rebates that a pharmaceutical manufacturer pays pursuant to the Medicaid Rebate Program.[48]

<u>Income tax treatment of employer stock transferred to an employee</u>

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services.[49] These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction. In the case of stock transferred to an employee, the employer is generally allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee's income as a result of transfer of the stock.[50] An employee generally must recognize income for the taxable year in which the employee's right to the stock is first substantially vested (*i.e.*, the earlier of when the stock is transferable or not subject to a substantial risk of forfeiture).[51] Thus, if the employee's right to the stock is substantially vested when the employee receives the stock (*e.g.*, a bonus stock award), income is recognized (and a corresponding employer deduction is generally allowed) for the taxable year in which received. If the employee's right to the stock is not substantially vested at the time of receipt (*e.g.*, a restricted stock award or restricted stock unit), income is generally recognized (and a corresponding employer deduction is generally allowed) for the taxable year in which the employee's right becomes substantially vested.[52] The amount includible in the employee's

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[46] See sec. 461(h) and Treas. Reg. sec. 1.461-5. See also FAA 20121602F (Apr. 20, 2012).

[47] See Rev. Rul. 2008-26, 2008-21 I.R.B. 985.

[48] *Ibid*.

[49] Sec. 83.

[50] Sec. 83(h). The deduction is allowed for the employer's taxable year in which or with which ends the taxable year for which the amount is included in the employee's income. The amount of the deduction may be limited by section 162(m) if the stock is granted to a covered employee (as defined in section 162(m)(3)), and it could be subject to capitalization under section 263A if, for example, the stock is granted to an employee involved in production activities.

[51] See section 83(c) for the definition of substantial risk of forfeiture.

[52] Under section 83(b), if an employee's right to the stock is property is not substantially vested at the time of receipt, the employee may nevertheless elect within 30 days of receipt to recognize income for the taxable year of receipt. The employee makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of receipt and the amount (if any) paid for the property. The employee must also

income is the excess of the fair market value of the stock over the amount, if any, paid for the stock.[53]

Limitation on deduction for interest

The amount allowed as a deduction for business interest for a taxable year is generally limited to the sum of: (1) the business interest income of the taxpayer for the taxable year, (2) 30 percent of adjusted taxable income of the taxpayer for the taxable year (not less than zero), and (3) the floor plan financing interest of the taxpayer for the taxable year.[54] Thus, other than floor plan financing interest, business interest expense in excess of business interest income is generally deductible only to the extent of 30 percent of adjusted taxable income.[55] The amount of any business interest expense not allowed as a deduction for any taxable year may be carried forward indefinitely. The limitation generally applies at the taxpayer level (although special carryforward rules apply in the case of partnerships). In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.[56]

Adjusted taxable income for purposes of section 163(j) generally means the taxable income of the taxpayer (A) computed without regard to (i) any item of income, gain, deduction, or loss that is not properly allocable to a trade or business; (ii) any business interest or business interest income; (iii) the amount of any net operating loss deduction; (iv) the amount of any deduction allowed under section 199A; and (v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion; and

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provide a copy of the statement to the employer. A section 83(b) election is available with respect to grants of restricted stock (*i.e.*, nonvested stock), and does not generally apply to the grant of options. Alternatively, under section 83(i), certain employees of privately held corporations may make an election to defer income that would otherwise be recognized under section 83(a) upon the exercise or settlement of qualified equity grants. For a description of section 83(i), see Joint Committee on Taxation, *General Explanation of Public Law No. 115-97* (JCS-1-18), December 2018, pp. 266-276. See also IRS Notice 2018-97, 2018-52 I.R.B. 1062 (providing guidance on the section 83(i) election).

[53] Sec. 83(a). See Treas. Reg. sec. 1.83-7(a) for rules governing the taxation of nonqualified stock options.

[54] Sec. 163(j). Taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $29 million (for 2023) and certain regulated public utilities are not subject to this limitation. Sec. 163(j)(7)(A)(iv). Taxpayers in real property or farming trades or businesses (as defined in section 163(j)(7)(B) and (C)) may elect not to be subject to this limitation.

[55] For taxable years beginning in 2019 or 2020, the limitation was 50 percent. Sec. 163(j)(10)(A)(i). In addition, a taxpayer could elect to substitute its 2019 adjusted taxable income for its 2020 adjusted taxable income. Sec. 163(j)(10)(B). For a detailed description of section 163(j) and the special rules applicable to taxable years beginning in 2019 and 2020, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 116th Congress* (JCS-1-22), February 2022, pp. 335-340.

[56] See Treas. Reg. sec. 1.163(j)-4(d) (providing that a consolidated group has a single section 163(j) limitation and generally treating all members of the consolidated group as a single taxpayer for section 163(j) purposes).

(B) computed with such other adjustments as provided by the Secretary.[57] For taxable years beginning after December 31, 2021, adjusted taxable income for purposes of the section 163(j) limitation on business interest is computed with regard to any deduction for depreciation, amortization, or depletion.[58]

Charitable contributions of inventory

In general, an income tax deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization.[59] Charitable contributions of cash are deductible in the amount contributed. Subject to several exceptions, contributions of property are deductible at the fair market value of the property. One exception provides that the amount of the charitable contribution is reduced by the amount of any gain which would not have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value at the time of the contribution.[60] As a result of this exception, a taxpayer's deduction for charitable contributions of inventory generally is limited to the lesser of the taxpayer's basis in the inventory or the fair market value of the inventory. However, for certain contributions of inventory, a C corporation may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (*i.e.*, basis plus one-half of the fair market value in excess of basis), or (2) two times basis.[61] To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants; (2) not transfer the property in exchange for money, other property, or services; and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.[62] In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, as amended (*e.g.*, drugs, medical devices, etc.), the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.[63] In addition, if a taxpayer contributes inventory at a time when it could not reasonably expect to realize its usual selling price (*e.g.*, a donation of drugs close to their expiration date),

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[57] Sec. 163(j)(8).

[58] Sec. 163(j)(8)(v).

[59] Sec. 170.

[60] Sec. 170(e)(1)(A).

[61] Sec. 170(e)(3)(B).

[62] Sec. 170(e)(3)(A)(i) to (iii).

[63] Sec. 170(e)(3)(A)(iv). The Federal Food, Drug, and Cosmetic Act and subsequent amending statutes are codified into Title 21, Chapter 9, of the U.S. Code.

the value of the item is not its usual selling price, but rather the amount for which the item would have been sold at the time of the contribution.[64]

Charitable contributions by a C corporation generally may not exceed 10 percent of the corporation's taxable income for the taxable year.[65] Excess contributions may be carried forward for up to five taxable years.[66] Thus, the enhanced deduction may be limited, depending on the corporation's taxable income for the taxable year of the contribution.

NOL deduction

For NOLs arising in taxable years beginning after 2020, the NOL deduction is generally limited to 80 percent of taxable income (computed without regard to the NOL deduction and deductions under sections 199A and 250), and excess losses generally may be carried forward indefinitely, but not back (with certain exceptions).[67]

4. Recovery of capital expenditures

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[68] The period for depreciation or amortization generally begins when the asset is placed in service by the taxpayer.[69]

Additional first-year depreciation deduction

An additional first-year depreciation deduction is allowed equal to 100 percent of the adjusted basis of qualified property acquired after September 27, 2017, and placed in service before January 1, 2023 (January 1, 2024, for certain property with a recovery period of at least

[64] Treas. Reg. sec. 1.170A-1(c)(3). See also Rev. Rul. 85-8, 1985-1 C.B. 59 (dealing with a pharmaceutical manufacturer's charitable contribution of products shortly before their expiration date).

[65] Sec. 170(b)(2)(A). In the case of sole proprietorships, S corporations, or partnerships (or other non-C corporations), different limitations apply at the individual owner, shareholder, or partner (or member) level depending on the type of recipient organization and property contributed. See sec. 170(b)(1).

[66] Sec. 170(d)(2).

[67] Sec. 172. For a discussion of the rules that apply to NOLs arising in taxable years beginning before 2021, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 116th Congress* (JCS-1-22), February 2022, pp. 325-329.

[68] Secs. 263(a) and 167. In general, only the tax owner of property (*i.e.*, the taxpayer with the benefits and burdens of ownership) is entitled to claim tax benefits such as cost recovery deductions with respect to the property.

[69] Treas. Reg. secs. 1.167(a)-3, 1.167(a)-10(b), 1.167(a)-11(e)(1)(i), 1.167(a)-14, and 1.197-2(f).

10 years or certain transportation property,[70] and certain aircraft[71]).[72] The 100-percent allowance is phased down by 20 percent per calendar year for property acquired after September 27, 2017, and placed in service after December 31, 2022 (after December 31, 2023, for longer production period property and certain aircraft).[73] This additional first-year depreciation is commonly referred to as "bonus depreciation."[74]

Amortization of certain intangible assets

A taxpayer generally must capitalize certain amounts paid to acquire or create an intangible asset.[75] This includes amounts paid or incurred to acquire a patent, to obtain certain rights from a government agency, and any transaction costs incurred to facilitate such amounts (*e.g.*, legal fees).[76] Certain intangible assets are subject to 15-year straight-line amortization under section 197 ("section 197 intangibles").[77] Section 197 intangibles include, for example, any patent, copyright, formula, process, design, pattern, knowhow, format, or similar item; any license, permit, or other right granted by a governmental unit; and any franchise, trademark, or trade name.[78] However, certain rights acquired separately from the acquisition of assets constituting a trade or business (or substantial portion thereof) are not subject to 15-year amortization under section 197 and are instead subject to amortization under section 167, depending on the type of interest or right separately acquired.[79] For example, an interest in a patent that is not acquired as part of the acquisition of a trade or business is not a section 197

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[70] Property qualifying for the extended placed-in-service date must have a recovery period of at least 10 years or constitute transportation property, have an estimated production period exceeding one year, and have a cost exceeding $1 million. Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property. Sec. 168(k)(2)(B). Property defined in section 168(k)(2)(B) is hereinafter collectively referred to as "longer production period property."

[71] Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed-in-service date, if at the time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or $100,000, and which has an estimated production period exceeding four months and a cost exceeding $200,000. Sec. 168(k)(2)(C).

[72] Sec. 168(k). The bonus depreciation deduction is generally subject to the rules regarding whether a cost must be capitalized under section 263A.

[73] Sec. 168(k)(6)(A) and (B).

[74] For a detailed description of bonus depreciation, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021.

[75] Treas. Reg. sec. 1.263(a)-4(c) and (d).

[76] Treas. Reg. sec. 1.263(a)-4(c)(1)(vii), (d)(5)(i), and (e).

[77] Sec. 197(a); Treas. Reg. sec. 1.197-2(f).

[78] Sec. 197(d)(1).

[79] See sec. 197(e)(4) and Treas. Reg. sec. 1.167(a)-14.

intangible, but instead is generally amortized either over the patent's remaining useful life or under the income forecast method of section 167(g).[80]

In the pharmaceutical industry, capitalizable amounts paid to obtain or facilitate a governmental right include those amounts attributable to new drug applications ("NDA")[81] and abbreviated new drug applications ("ANDA")[82] filed with the U.S. Food and Drug Administration ("FDA") (*e.g.*, legal fees incurred in connection with preparing the applications and obtaining FDA approval).[83] Once approved by the FDA, an NDA or ANDA is generally amortizable under section 197 (*i.e.*, generally recovered ratably over a 15-year period, beginning on the first day of the month the FDA approval is obtained).[84] Similarly, the cost of acquiring a priority review voucher ("PRV") from a third-party pharmaceutical company in order to expedite the processing of an NDA filed with the FDA is generally required to be capitalized, and then may subsequently be amortized under section 197 beginning in the month that the FDA approves the NDA.[85] Alternatively, if a taxpayer does not use a PRV to expedite the processing of an NDA filed with the FDA and instead intends to resell it or hold it for investment, the cost of the PRV is not amortizable, but rather will generally be recovered through the recognition of gain or loss when the taxpayer sells, transfers, or exchanges the PRV.[86]

Pharmaceutical companies also generally incur significant legal expenses to defend patent infringement litigation. While expenses to defend or perfect title to intangible property are generally capitalizable,[87] patent infringement expenses are generally deductible as ordinary

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[80] Sec. 167(g)(6)(D); Treas. Reg. sec. 1.167(a)-14(c)(4). Under the income forecast method, a property's depreciation deduction for a taxable year is generally determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property is placed in service. See sec. 167(g).

[81] A drug manufacturer formally proposes that the FDA approve the new drug for sale and marketing in the United States through an NDA. See, *e.g.*, *Actavis Laboratories FL Inc. v. United States*, 161 Fed. Cl. 334 (2022) ("*Actavis*"); and *Mylan, Inc. & Subsidiaries v. Commissioner,* 156 T.C. 137 (2021) ("*Mylan*").

[82] A generic drug manufacturer may submit an ANDA that piggybacks on an approved brand name drug's NDA by specifying that the generic has the same active ingredients as, and is biologically equivalent to, the already-approved brand name drug. See *Actavis and Mylan*, *supra*.

[83] Sec. 263(a); Treas. Reg. sec. 1.263(a)-4(b)(1)(v), (c)(1)(viii), and (d)(5). See also, *Actavis, supra; Mylan*, *supra*; and FAA 20114901F, September 14, 2011.

[84] See *Mylan, supra*; and FAA 20114901F, September 14, 2011.

[85] See IRS Chief Counsel Advice 202304009, December 22, 2022. The PRV Program accelerates the approval and marketability of new treatments for certain neglected and rare diseases. See 21 U.S. Code secs. 360n (tropical diseases), 360ff (rare pediatric diseases), and 360bbb-4a (agents that present national security threats). Congress most recently renewed expiring PRV Programs in sec. 321 of Title III of Subdivision BB of the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260.

[86] *Ibid*.

[87] Treas. Reg. sec. 1.263(a)-4(d)(9).

and necessary trade or business expenses to defend against gains or profits lost by the patent owner.[88] For example, the Tax Court recently held in *Mylan* that legal expenses incurred by a pharmaceutical manufacturer to defend against patent infringement lawsuits, including those related to ANDAs filed by the taxpayer, are deductible ordinary and necessary business expenses.[89] However, the IRS generally views NDA and ANDA litigation expenses as capitalizable amounts paid to acquire, create, or facilitate an intangible asset (*i.e.*, as costs incurred in pursuing FDA approval of the NDA or ANDA), and has appealed the Tax Court's ruling in *Mylan* with respect to the treatment of such costs to the Third Circuit Court of Appeals.[90]

<u>Capitalization and recovery of research and experimentation expenditures</u>

For taxable years beginning after December 31, 2021, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably over a five-year period (15-year period for expenditures that are attributable to research that is conducted outside of the United States[91]), beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred.[92] Specified research or experimental expenditures subject to capitalization include expenditures for software development.[93] Specified research or experimental expenditures exclude expenditures for the acquisition or improvement of land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of

[88] See *Mylan* and *Actavis*, *supra,* and *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970).

[89] *Supra.* In holding that the patent litigation expenses related to the ANDAs filed by the taxpayer were deductible, the Tax Court noted that "[a]lthough the filing of an ANDA … triggers the opportunity for patent litigation as well as the FDA review process, this statutory design does not transform the patent litigation into a step in the ANDA approval process." 156 T.C. at 156-157.

[90] See *Mylan v. Commissioner*, No. 22-1193 (3rd Cir. 2022).

[91] For this purpose, the term "United States" includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States. Sec. 174(a)(2)(B), by reference to 41(d)(4)(F).

[92] Sec. 174(a). For taxable years beginning before January 1, 2022, taxpayers may elect to: (1) deduct currently research or experimental expenditures (former sec. 174(a), prior to amendment by Public Law 115-97), (2) capitalize research or experimental expenditures and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months (former sec. 174(b), prior to amendment by Public Law 115-97), or (3) capitalize and amortize research or experimental expenditures over a period of 10 years (sec. 59(e)). The election under section 59(e) to amortize research or experimental expenditures over a 10-year period does not apply to research or experimental expenditures incurred in taxable years beginning after December 31, 2021. A technical correction may be necessary to reflect this intent. Guidance published by the IRS is consistent with this intent. See the 2022 Instructions for Form 4562, *Depreciation and Amortization (Including Information on Listed Property)*, p. 15; and IRS Publication 535, *Business Expenses*, p. 36. See also, Joint Committee on Taxation, *Technical Explanation of the House Ways and Means Committee Chairman's Discussion Draft of the "Tax Technical and Clerical Corrections Act"* (JCX-1-19), January 2, 2019, p. 7; and the "Tax Technical and Clerical Corrections Act" Discussion Draft, p. 18, available.at https://republicans-waysandmeansforms house.gov/uploadedfiles/tax_technical_and_clerical_corrections_act_discussion_draft.pdf (last accessed May 4, 2023).

[93] Sec. 174(c)(3).

such property.[94] Research or experimental expenditures also exclude the costs of acquiring another person's patent, model, production, or process (commonly referred to as "in-process R&D").[95]

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.[96]

5. U.S. tax rules applicable to foreign activities of U.S. taxpayers

In general, income earned directly by a U.S. person from the conduct of a foreign trade or business is taxed currently,[97] while income earned indirectly through certain related foreign entities (*i.e.*, controlled foreign corporations ("CFCs"))[98] is taxed in the year earned or not at all. Indirect earnings of CFCs are generally taxable in one of two ways. First, the earnings may constitute income to U.S. shareholders under the traditional anti-deferral regime of subpart F, which applies to certain passive income and certain other related-party income that is readily movable from one jurisdiction to another.[99] Second, the earnings may be subject to section 951A, which applies to some foreign-source income of a CFC that is not subpart F income (referred to as global intangible low-taxed income ("GILTI")). Subpart F income is taxed at full rates, while GILTI is taxed at preferential rates, both without regard to whether the income is distributed to shareholders. The preferential rate on GILTI is achieved by means of allowing corporations a 50-percent deduction (a "section 250 deduction") on their GILTI (and the

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[94] Sec. 174(c)(1).

[95] Treas. Reg. sec. 1.174-2(a)(6)(vi).

[96] Sec. 174(d).

[97] Such income is called foreign branch income. See sec. 904(d)(2)(J).

[98] A CFC generally is defined as any foreign corporation in which U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only "U.S. shareholders," that is, U.S. persons that own at least 10 percent of the stock (measured by vote or value). Secs. 951(b), 957, and 958. Special rules apply with respect to U.S. persons that are shareholders (regardless of their percentage ownership) in any foreign corporation that is not a CFC but is a passive foreign investment company ("PFIC"). See secs. 1291 through 1298. The PFIC rules generally seek to prevent the deferral of passive income through the use of foreign corporations.

[99] Subpart F comprises sections 951 through 965.

corresponding section 78 gross up amount).[100] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income.[101]

Foreign earnings not subject to tax as subpart F income or GILTI generally are exempt from U.S. tax. To exempt those earnings, dividends received by corporate U.S. shareholders from specified 10-percent owned foreign corporations (including CFCs) generally are eligible for a 100-percent dividends-received deduction ("DRD").[102]

For a deeper discussion of select issues, see Part II.B. below.

[100] Sec. 250(a)(1)(B). The section 250 deduction for GILTI is only available for C corporations that are neither regulated investment companies ("RICs") nor real estate investment trusts ("REITs"). The section 250 deduction also applies with respect to foreign-derived intangible income of certain corporations, discussed in more detail below.

[101] Foreign tax credits limited in a tax year generally may be carried back one year or forward 10 years. Sec. 904(c). In contrast with the general rules allowing carrybacks and carryovers of excess foreign tax credits, no carrybacks or carryovers of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category. In addition, a 20-percent foreign tax credit disallowance applies to foreign income taxes paid with respect to GILTI. Sec. 960(d). Foreign tax credits are not available for foreign taxes paid or accrued with respect to dividends qualifying for the 100-percent dividends received deduction. Sec. 245A(d).

[102] Sec. 245A. The DRD is not limited to dividends from CFCs, but rather may be available with respect to any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a U.S. shareholder with respect to such foreign corporation.

B. Corporate Tax Liability

1. In general

A domestic corporation generally is subject to Federal income tax at a rate of 21 percent rate.[103] Domestic corporations that are affiliated through 80-percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns.[104] Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one corporation can offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Certain corporations whose annual gross receipts meet or exceed certain thresholds are subject to an additional tax under section 59A (the base erosion and anti-abuse tax, discussed below).

In contrast to the treatment of capital gains in the individual income tax, no separate rate structure exists for corporate capital gains. A corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year. Disallowed capital losses may be carried back three years or carried forward five years.

Corporations generally are taxed at lower rates on their foreign-derived intangible income ("FDII").[105] The preferential rate is accomplished by the allowance of a 37.5-percent deduction under section 250, resulting in an effective tax rate of 13.125 percent on FDII (discussed below).

2. Corporate alternative minimum tax

For taxable years beginning after December 31, 2022, large C corporations meeting certain requirements ("applicable corporations") are subject to a new corporate alternative minimum tax that is based on adjusted financial statement income.[106] The tax equals the excess (if any) of (1) the tentative minimum tax for the taxable year, over (2) the regular tax (as defined in section 55(c)) plus the tax imposed by section 59A for the taxable year.[107] The tentative minimum tax for an applicable corporation for a taxable year is the excess of (i) 15 percent of the

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[103] Sec. 11.

[104] See secs. 1501-1504.

[105] A corporation's FDII is its deemed intangible income multiplied by the percentage of its income (computed with certain exceptions) derived from serving foreign markets. A corporation's deemed intangible income is the excess of its income (computed with certain exceptions) over a 10-percent return on the aggregate of its average quarterly adjusted bases in certain depreciable tangible property. The deduction for FDII is not available for RICs or REITs. Sec. 250.

[106] See secs. 53(e), 55(b)(2), 56A and 59(k) and (l).

[107] Sec. 55(a).

adjusted financial statement income ("AFSI," as reduced by certain financial statement NOLs[108]) for the taxable year, over (ii) the book minimum tax foreign tax credit for such taxable year.[109] In the case of any corporation that is not an applicable corporation, the tentative minimum tax for the taxable year is zero.[110] In general, an applicable corporation is entitled for any taxable year to a credit against its Federal income tax in an amount equal to the minimum tax credit for such taxable year.[111]

Section 56A sets forth the general definition of AFSI, which is used for purposes of determining the corporate alternative minimum tax liability and, with certain modifications provided in section 59(k), for purposes of determining whether a corporation is an applicable corporation subject to the corporate alternative minimum tax. AFSI is the net income or loss of the taxpayer set forth on the taxpayer's applicable financial statement for such taxable year, adjusted as set forth in section 56A. Adjustments to net financial statement income include adjustments for: (1) statements covering different taxable years, (2) consolidated tax returns, (3) dividends and other amounts, (4) earnings of certain partnerships, (5) certain foreign income, (6) certain Federal and foreign taxes, (7) income of disregarded entities, (8) patronage dividends and per-unit retain allocations of cooperatives, (9) certain items of Alaska Native Corporations, (10) amounts attributable to elections for direct payment of certain credits, (11) reasonable mortgage servicing income, (12) defined benefit pensions, (13) tax-exempt entities, (14) depreciation, and (15) qualified wireless spectrum. The Secretary is directed to issue regulations to prevent the omission or duplication of any item, to address corporate organizations and reorganizations, and to address the effect of these provisions on partnerships with an applicable corporation as a partner.

In general, a corporation is an applicable corporation subject to the corporate alternative minimum tax if it meets the average annual AFSI test for one or more taxable years which are prior to such taxable year, and end after December 31, 2021.[112] A corporation meets such test for a taxable year if its average annual AFSI for the three-taxable-year period ending with such taxable year exceeds $1 billion. In the case of a foreign-parented corporation, there is an additional test requiring that the average annual AFSI of the corporation (not including income of the group not subject to U.S. tax) for the three-taxable-year period ending with such taxable be

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[108] Solely for purposes of determining an applicable corporation's alternative minimum tax liability, AFSI is reduced by the lesser of the aggregate amount of financial statement NOL carryovers to the taxable year, or 80 percent of the AFSI computed without regard to the financial statement NOL deduction. Financial statement NOL carryovers are the amount of net loss (if any) set forth on the corporation's applicable financial statement for taxable years ending after December 31, 2019. See sec. 56A(d) (providing the AFSI deduction for a financial statement NOL) and 59(k)(1)(B) (disregarding the AFSI deduction for a financial statement NOL for purposes of determining whether a corporation meets the average annual AFSI test).

[109] Secs. 55(b)(2) and 59(l).

[110] Sec. 55(b)(2)(B).

[111] Sec. 53(e).

[112] Sec. 59(k).

$100 million or more. Aggregation rules and certain adjustments apply in determining AFSI for purposes of determining whether a corporation is an applicable corporation.[113]

3. Tax credits

General business credits, including the research credit and orphan drug credit (discussed below), generally may offset up to approximately 75 percent of the sum of a corporation's normal income tax and alternative minimum tax.[114] Any general business credit in excess of this limitation generally may be carried back one year and forward up to 20 years.[115]

Corporations may reduce their tax liability by any applicable general business credits.[116] The three largest dollar amount credits are the research credit (discussed below), the low-income housing credit, and the energy credit, which provide incentives for intangible investment, affordable housing investment, and energy production, respectively.[117] Other credits applicable to businesses include the orphan drug credit (discussed below), investment tax credits (including an investment credit for qualified investments in an advanced manufacturing facility (*i.e.*, a semiconductor manufacturing facility)), the work opportunity credit (applicable to a portion of first-year wages paid to individuals from certain targeted groups), the employer-provided child care credit (applicable to certain expenditures to provide child care for employees), and the employer credit for paid family and medical leave (applicable to wages paid to employees on family and medical leave).[118]

<u>Research credit</u>

A taxpayer may generally claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.[119] Thus, the research credit is generally available with respect to incremental increases

[113] See sec. 59(k).

[114] Sec. 38.

[115] Sec. 39.

[116] Business credits also apply to the business income of individuals.

[117] See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026* (JCX-22-22), December 22, 2022.

[118] Certain of these credits are scheduled to expire in 2024 or later. For more information on expiring provisions of the Code, see Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2022-2034* (JCX-1-23), January 18, 2023.

[119] Sec. 41(a)(1). For a detailed description of the research credit, see Joint Committee on Taxation, *Tax Incentives for Domestic Manufacturing* (JCX-15-21), March 12, 2021.

in qualified research. An alternative simplified credit (with a 14-percent rate and a different base amount) may be claimed in lieu of this credit.[120]

A 20-percent research credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.[121] This separate credit computation commonly is referred to as the "basic research credit."

Finally, a 20-percent research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium for energy research.[122] This separate credit computation commonly is referred to as the "energy research credit." Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

Orphan drug credit

Section 45C provides a 25-percent tax credit for qualified clinical testing expenses incurred in the testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the FDA but before the drug has been approved for sale by the FDA.[123] A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that a business could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug.[124]

Amounts included in computing the credit under this section are excluded from the computation of the research credit under section 41.[125] If a taxpayer claims the orphan drug credit, it either (i) reduces its otherwise allowable deduction for qualified clinical testing

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[120] Sec. 41(c)(4).

[121] Sec. 41(a)(2) and (e). The base period for the basic research credit generally extends from 1981 through 1983.

[122] Sec. 41(a)(3).

[123] Sec. 45C(b).

[124] Sec. 45C(d)(1).

[125] Sec. 45C(c).

expenses by the amount of the credit allowed, or (ii) elects a reduced credit by an amount equal to the credit multiplied by the highest corporate tax rate.[126]

4. Excise taxes

Excise tax on certain stock repurchases

In the case of repurchases of stock after December 31, 2022, section 4501 imposes a nondeductible[127] one percent excise tax on the aggregate fair market value of stock that a covered corporation repurchases during the taxable year, subject to certain adjustments and exceptions. A covered corporation is any domestic corporation the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)).[128]

Annual fee on branded prescription pharmaceutical manufacturers and importers

An annual fee is imposed on covered entities engaged in the business of manufacturing or importing branded prescription drugs for sale to any specified government program or pursuant to coverage under any such program.[129] The aggregate annual fee imposed on all covered entities is $2.8 billion for calendar year 2023.[130] The aggregate fee is apportioned among the covered entities each year based on their relative market share of branded prescription drug sales taken into account during the previous calendar year. A covered entity is any manufacturer or importer with gross receipts from branded prescription drug sales. The fee is considered to be a nondeductible tax for purposes of section 275 and therefore is not deductible against income taxes.[131]

Excise tax on taxable vaccines

An excise tax is imposed on any taxable vaccine sold by the manufacturer, producer, or importer of such vaccine.[132] Manufacturers, producers, and importers are responsible for paying

[126] Sec. 280C(b).

[127] Sec. 275(a)(6).

[128] In addition, the provision may apply to certain acquisitions of stock of foreign corporations (*e.g.*, acquisitions of stock of covered surrogate foreign corporations, defined as any surrogate foreign corporation (as determined under section 7874(a)(2)(B) by substituting "September 20, 2021" for "March 4, 2023" each place it appears) the stock of which is traded on an established securities market (within the meaning of section 7704(b)(1)). Sec. 4501(d)(2).

[129] Sec. 9008 of the Patient Protection and Affordable Care Act ("PPACA"), Pub. L. No. 111-148, as amended by section 1404 of the Health Care and Education Reconciliation Act of 2010 ("HCERA")), Pub. L. No. 111-152.; *see also* Treas. Reg. sec. 51.1 - 51.11.

[130] Sec. 90008(b)(4) of the PPACA. The aggregate annual fee amount for each year is set by statute; for calendar year 2019 and thereafter the amount is $2.8 billion. *Ibid*.

[131] Sec. 9008(f)(2) of the PPACA.

[132] Sec. 4131.

75 cents per dose of a taxable vaccine upon the sale of the vaccine, but the tax does not apply if it has already been imposed on a prior sale of such vaccine.[133] Vaccines which include multiple taxable vaccines are taxed cumulatively as if each taxable vaccine were a separate dose—that is, if two taxable vaccines are combined, then the tax imposed is $1.50 per dose.[134] Similarly, fractional doses are taxed at the same fraction of the amount of such tax imposed on a whole dose.[135] Doses which are used by a manufacturer, producer, or importer before being sold are taxed as if the vaccine were sold by such manufacturer, producer, or importer.[136]

Excise tax for noncompliance with the Drug Price Negotiation Program

Applicable pharmaceutical manufacturers, producers, and importers who do not comply with certain requirements of the Drug Price Negotiation Program administered by the Secretary of Health and Human Services ("HHS")[137] are subject to a nondeductible excise tax ranging from 65 to 95 percent on designated drug sales during periods of noncompliance.[138]

5. The base erosion and anti-abuse tax

The base erosion and anti-abuse tax (the "BEAT") is an additional tax imposed on certain multinational corporations with respect to payments to foreign affiliates.[139]

The BEAT applies only to corporate taxpayers with average gross receipts in excess of $500 million and is determined, in part, by the extent to which a taxpayer has made payments to foreign related parties.[140] The BEAT generally does not apply to taxpayers for which reductions to taxable income ("base erosion tax benefits") arising from payments to foreign related parties ("base erosion payments") are less than three percent of total deductions (*i.e.*, a "base erosion percentage" of less than three percent).[141]

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[133] Secs. 4131(b)(1) and 4132(b)(4).

[134] Sec. 4131(b)(2).

[135] Sec. 4132(c)(3).

[136] Sec. 4132(c)(1).

[137] Part E of Title XI of the SSA, secs. 1191-1198 of the SSA.

[138] Sec. 5000D, enacted by Pub. L. No. 117-169, August 16, 2022.

[139] Sec. 59A.

[140] For this purpose, a related party is, with respect to the taxpayer, any 25-percent owner of the taxpayer; any person who is related (within the meaning of sections 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer; and any other person who is related (within the meaning of section 482) to the taxpayer. Sec. 59A(g). The 25-percent ownership threshold is determined by vote or value.

[141] Sec. 59A(e).

A base erosion tax benefit generally reflects the reduction in taxable income arising from the associated base erosion payment. A base erosion payment generally is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable.[142] A base erosion payment includes any amount paid or accrued by the taxpayer to a foreign related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).[143] Base erosion payments generally do not include any amount that constitutes a reduction in gross receipts, including payments for cost of goods sold. Certain other payments are excluded from the definition of base erosion payment, including certain payments for services[144] and any qualified derivative payments.[145]

For a taxpayer subject to the BEAT (an "applicable taxpayer"), the additional tax (the "base erosion minimum tax amount" or "BEAT liability") for the year generally equals the excess, if any, of 10 percent of its modified taxable income over an amount equal to its regular tax liability[146] reduced (but not below zero) by the sum of a certain tax credits under chapter 1 of the Code.[147] Modified taxable income is the taxpayer's regular taxable income determined without regard to a certain portion of any NOL deduction allowed for the taxable year and without regard to any base erosion tax benefit with respect to certain items (*i.e.*, base erosion payments), including (1) certain deductible payments made to foreign related parties, (2) deductions allowed for depreciation (or amortization in lieu of deprecation) with respect to property acquired from foreign related parties, and (3) reinsurance premiums paid to foreign related parties.[148]

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[142] Sec. 59A(d)(1).

[143] Sec. 59A(d)(2). A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign related party for any reinsurance payments that are taken into account under section 803(a)(1)(B) or 832(b)(4)(A). Sec. 59A(d)(3).

[144] Sec. 59A(d)(5).

[145] Sec. 59A(h); see also Treas. Reg. sec. 1.59A-3(c)(6) (providing an election to waive certain deductions to reduce "allowed deductions" for purposes of determining base erosion tax benefit).

[146] As defined in section 26(b).

[147] Sec. 59A(b). Credits that reduce regular tax liability (*i.e.*, increase the base erosion minimum tax amount, if any) are all section 38 credits except for (1) the research credit and (2) applicable section 38 credits. Applicable section 38 credits are the low-income housing credit, the renewable electricity production credit, and the energy investment credit. The exception for applicable section 38 credits generally may not reduce the base erosion minimum tax amount by more than 80 percent (determined without regard to the exception for applicable section 38 credits). Sec. 59A(b)(1)(B)(i)(II).

[148] An applicable taxpayer's modified taxable income is its taxable income for the taxable year increased by (1) any base erosion tax benefit with respect to any base erosion payment and (2) the base erosion percentage of any NOL deduction allowed under section 172 for such taxable year. Sec. 59A(c)(1).

Special rules apply to banks and securities dealers.[149] For taxable years beginning after December 31, 2025, the 10-percent rate on modified taxable income is increased to 12.5 percent, and regular tax liability is reduced (and the base erosion minimum tax amount is therefore increased) by the sum of all the taxpayer's income tax credits for the taxable year.[150]

6. Transition tax on U.S. shareholders of certain controlled foreign corporations

In 2017, many changes were made to the taxation of the foreign activities of U.S. persons, which had the effect of moving the United States from a worldwide system with limited deferral toward a participation exemption system with current inclusion of certain additional income. As part of the transition to this new participation exemption system, Congress enacted a one-time tax (the "transition tax") on undistributed foreign earnings that accrued before the effective date of the new system. The transition tax allowed for the uniform applicability of the participation exemption with respect to post-enactment foreign earnings of foreign subsidiaries.

The transition tax requires certain foreign corporations to include as subpart F income the untaxed and undistributed foreign earnings that were accumulated by those corporations in taxable years since 1986. The U.S. shareholders of those corporations are subject to the transition tax with respect to the shareholders' pro rata shares of such subpart F income.

The transition tax generally applies for the last taxable year beginning before January 1, 2018, requiring that any U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the accumulated post-1986 deferred foreign income of the corporation. However, a portion of that pro rata share of foreign earnings is deductible, depending on the proportion of the deferred earnings that are held in cash or other assets. The structure of the allowable deduction results in a bifurcated rate of tax on amounts required to be included in income: the rate is 15.5 percent for cash assets and eight percent for noncash assets. A corresponding portion of the credit for foreign taxes paid with respect to such income is disallowed, thus limiting the credit to the taxable portion of the included income.[151] A U.S. shareholder may elect to forgo the use of an NOL deduction to offset the amount included under the transition tax, and if the U.S. shareholder so elects, neither the section 951 inclusion nor any related deemed paid foreign tax credits may be taken into account in computing the NOL deduction for that year.[152]

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[149] Sec. 59A(b)(3) (providing that an applicable taxpayer that is a member of an affiliated group that includes a bank (as defined in section 581) or securities dealer registered under section 15(a) of the Securities Exchange Act of 1934 is subject to a tax rate on its modified taxable income that is one-percentage point higher than the generally applicable tax rate) and (e)(1)(C) (providing that for purposes of determining whether they are subject to the BEAT, banks and securities dealers are subject to a base erosion percentage threshold of two percent (rather than three percent)).

[150] Sec. 59A(b)(2).

[151] The separate foreign tax credit limitation rules of section 904 continue to apply, with coordinating rules.

[152] Sec. 965(n).

A taxpayer may elect to pay the transition tax over an eight-year period without accruing underpayment interest. Special rules are provided for S corporations and REITs.

II. OVERVIEW OF SELECT ISSUES OF U.S. TAXATION OF CROSS-BORDER ACTIVITY

The following discussion provides an overview of select principles, issues, and rules relating to the U.S. taxation of income from cross-border business activity of large U.S. multinational corporations, including those in the pharmaceutical industry, as well as a general description of the current status of the Organisation for Economic Cooperation and Development's proposed two-pillar solution to addressing certain base-erosion and profit shifting concerns.

A. Select U.S. Tax Rules Common to Inbound and Outbound Taxation

The United States imposes source-based taxation on U.S.-source income of nonresident alien individuals and other foreign persons. Under this system, the application of the Code differs depending on whether income arises from outbound investment (*i.e.*, foreign investments by U.S. persons) or inbound investment (*i.e.*, U.S. investment by foreign persons). While the United States taxes inbound and outbound investment differently, certain rules are common to the taxation of both, including rules relating to residency, entity classification, source determination, and transfer pricing.

1. Residence

The Code defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, trusts and estates.[153] Partnerships and corporations are domestic if organized or created under the laws of the United States, any State, or the District of Columbia, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[154] All other partnerships and corporations (*i.e.*, those organized under the laws of foreign countries) are foreign.[155] Other jurisdictions may use factors such as situs or management and control to determine residence. As a result, legal entities may have more than one tax residence, or, in some cases, no residence. In such cases, bilateral treaties may resolve conflicting claims of residence.

<u>Exception for corporate inversions</u>

In certain cases, a foreign corporation that acquires a domestic corporation or partnership may be treated as a domestic corporation for Federal tax purposes.[156] That result generally applies following a transaction in which, pursuant to a plan or a series of related transactions:

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[153] Sec. 7701(a)(30).

[154] Sec. 7701(a)(4).

[155] Sec. 7701(a)(5) and (9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

[156] Sec. 7874. The Treasury Department and the IRS have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under section 7874 since the section was enacted in 2004, and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions.

(1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (often referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50-percent ownership (the "expanded affiliated group"), does not have substantial business activities in the entity's country of organization, compared to the total worldwide business activities of the expanded affiliated group. If the above requirements are satisfied except that the "stock held by reason of" the acquisition is less than 80 percent, but at least 60 percent of the stock of the foreign corporation, the foreign corporation is not treated as a domestic corporation and is instead considered a surrogate foreign corporation for the acquired domestic company which is an expatriated entity that must recognize certain "inversion gain" post-acquisition restructuring[157] and may be subject to other consequences under the provisions enacted in 2017.[158]

Pharmaceutical companies have inverted in several mergers with foreign companies that have attracted attention.[159] Of the 60 inversions documented from 1983 through 2015, pharmaceutical companies experienced the most inversion activity.[160]

2. Entity classification

The Code defines various entity classifications, including partnership and corporation;[161] such classification matters for many Federal income tax purposes. In addition, certain entities other than "*per se*" corporations (*e.g.*, incorporated domestic business entities, banks, insurance

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[157] An excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. Sec. 4985. In addition, dividends from certain surrogate foreign corporations are excluded from qualified dividend income within the meaning of section 1(h)(11)(B) and are ineligible to be taxed as net capital gains. Sec. 1(h)(11)(C)(iii). As a result, individual shareholders in such corporations cannot claim the reduced rate on dividends otherwise available under section 1(h)(11).

[158] See secs. 59A(d)(4) (providing that payments made to expatriated entities that reduce gross receipts are base erosion payments) and 965(l) (disallowing the partial participation exemption deduction for computing the transition tax and assesses the additional transition tax in the year of inversion if an entity inverts within 10 years of the transition tax enactment).

[159] See $42.9 billion merger of Medtronic with Covidien plc in Ireland, and Mylan's $5.3 billion merger with the international division of Abbott Laboratories, available at: https://news medtronic.com/2014-06-15-Medtronic-to-Acquire-Covidien-for-42-9-billion-in-Cash-and-Stock#:~:text=%2D%20Medtronic%2C%20Inc.-,(NYSE%3A%20MDT)%2C%20a%20global%20leader%20in%20medical%20technology,a%20cash%2Dand%2Dstock%20transactionx, and https://www.prnewswire.com/news-releases/mylan-completes-acquisition-of-abbotts-non-us-developed-markets-specialty-and-branded-generics-business-300042793 html.

[160] CBO, "An Analysis of Corporate Inversions," September 2017, available at: https://www.cbo.gov/system/files/115th-congress-2017-2018/reports/53093-inversions.pdf

[161] Sec. 7701(a)(2) (defining partnership and partner) and (a)(3) (defining corporation).

companies, and any entity included in a list of foreign business entities)[162] are eligible to elect their classification. Under the so-called "check-the-box" regulations, these eligible entities may elect their classification as a corporation, a partnership, or an entity disregarded as separate from its owner ("DRE").[163] A DRE is treated in the same manner as a sole proprietorship, in the case of an entity owned by an individual, and in the same manner as a branch or division, in the case of an entity owned by a corporation or partnership. Both foreign and domestic entities may make the election.[164]

As a result of the check-the-box regulations, an entity formed in the United States and operating in at least one other jurisdiction may be treated as a hybrid entity (*i.e.*, treated as a partnership or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes) or a reverse hybrid entity (*i.e.*, treated as a corporation for U.S. tax purposes but as a partnership or disregarded entity for foreign tax purposes).

Congress has recognized that such hybrid entities or reverse hybrid entities may improperly reduce subpart F income, allow for payments that generate deductions without offsetting inclusions, and use tax treaties to reduce withholding tax on payments that are not subject to tax under the laws of any jurisdiction, and have accordingly attempted to limit their use as a tax planning tool.[165]

3. Source of income rules

Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor or recipient and the location of the activities or assets that generate the income. The Code includes extensive rules on determining whether income is considered to be

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[162] Treas. Reg. sec. 301.7701-2(b).

[163] Treas. Reg. sec. 301.7701-3.

[164] Following the statute, for purposes of the check-the-box regulations, an entity is "domestic" if it is created or organized in the United States or under the law of the United States; an entity is "foreign" if it is not domestic. Treas. Reg. sec. 301-7701-5(a); see generally sec. 7701(a)(4) and (5).

[165] See section 267A(a), which generally disallows a deduction for any interest or royalty paid to a related party to the extent that the amount is not included in the related party's income under the tax law of the country where the recipient is resident for tax purposes or is subject to tax, or the related party is allowed a deduction for the amount in that country. See also section 894(c), which denies treaty withholding tax benefits to foreign persons with respect to an item of income if the treaty partner does not view the foreign person as earning the item of income, the treaty does not have a provision addressing the treatment of an item of income derived by a partnership, and the foreign country does not impose tax on a distribution of such item of income from such entity to such foreign person. Section 894(c) was enacted in response to a perceived problem under the U.S.-Canada tax treaty involving a U.S. corporation and U.S. limited liability company ("LLC") both owned by a single Canadian corporation. The LLC makes loans to the U.S. corporation to finance the U.S. corporation's operations, with the U.S. corporation paying interest to the LLC. Because the LLC is treated as a partnership for U.S. tax purposes but as a corporation for Canadian tax purposes, the interest, while deductible for the U.S. corporation, is not includible as income of either the LLC or the Canadian owners; absent Sec. 894(c) the interest payments also would be eligible for decreased withholding tax under the tax treaty. See H.R. Rep. No. 148, 105th Congress, 1st Sess. 550 (1997).

from U.S. sources or from foreign sources.[166] Special rules are provided for certain industries, (*e.g.*, transportation, shipping, and certain space and ocean activities) as well as for income partly from within and partly from without the United States.[167]

While many rules for determining source have been unchanged over the years, changes made in 2017 addressed the sale of inventory by eliminating the title passage rule. Gains, profits, and income from the sale or exchange of inventory property that is either (1) produced (in whole or in part) inside the United States and then sold or exchanged outside the United States, or (2) produced (in whole or part) outside the United States and then sold or exchanged inside the United States is allocated and apportioned solely on the basis of the location of production activity.[168] For example, income derived from the sale of inventory produced entirely in the United States is wholly from U.S. sources, even if title passage occurs elsewhere. Likewise, income derived from the sale of inventory produced entirely in another country is wholly from foreign sources, even if title passage occurs in the United States. If inventory is produced only partly in the United States, the income derived from its sale is sourced partly in the United States regardless of where title to the property passes.

4. Transfer pricing

General rule—arm's length standard

Section 482 authorizes the Secretary to allocate income, deductions, credits, or allowances among related business entities when necessary to clearly reflect income or otherwise prevent tax avoidance. Comprehensive Treasury regulations under that section generally adopt the arm's-length standard as the method for determining whether a particular allocation is appropriate.[169] Under that standard, the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in a similar transaction with unrelated parties bargaining at arm's length. The arm's length standard is broadly accepted internationally, including all members of the OECD as well as many nonmembers.[170]

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[166] Sections 861 through 865, generally.

[167] Sec. 863.

[168] Sec. 863(b). The rules relating to the determination of source of income with respect to the sale of inventory are complex, and the results may differ depending, in part, on the relevant activities undertaken, the structure of the arrangement, and the entity classification of relevant participants. See, *e.g.*, secs. 861(a)(6), 862(a)(6), 863(b)(2), and 865(e)(2).

[169] Section 1059A buttresses section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

[170] OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* ("OECD Guidelines"), OECD Publishing, Paris, *https://doi.org/10.1787/0e655865-en*. The publication was approved by the OECD/G20 Inclusive Framework on BEPS on January 7, 2022.

Special rules for intangible property transfers

Section 482 requires that the income with respect to a transfer of intangible property be commensurate with the income attributable to the intangible. By requiring inclusion of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property—including, in particular, high-profit-potential intangibles.[171]

A U.S. person may transfer intangible property to a related person (typically, a foreign affiliate) in one of four ways: Outright transfer of the intangible property; a license of the intangible property, in which the U.S. person transfers less than all substantial rights in the intangible property to the foreign affiliate; the provision of a service by the U.S. person to the foreign affiliate using the intangible property, rather than a direct transfer of the property; and finally, a transfer by the U.S. person of intangible property through a qualified cost-sharing arrangement with one or more foreign affiliates, under which the participants make resources available and contribute funds (through a combination of cash and existing intangible property rights) toward the joint development of a new marketable product or service. A qualified cost-sharing arrangement is an agreement between taxpayers under common control that satisfies the requirements prescribed under regulations.[172] The method of transfer may determine whether the applicable section is section 482 or section 367(d).[173]

Despite consensus around the use of arm's length standard and extensive guidance, questions surrounding the difficulties posed by intercompany pricing requirements were raised, including recurring definitional and methodological issues and concerns about the use of aggressive transfer pricing.[174] In 2013, the OECD began a study of the existing international standards for transfer pricing and challenges presented by those standards in relation to intangible assets, risk and capital allocation, and other transactions which would not, or would only very rarely, occur between third parties.[175] Similar definitional and methodological issues

[171] H.R. Rep. No. 99-426, p. 423.

[172] Treas. Reg. sec. 1.482-7. See also OECD Guidelines, Chapter VIII "Cost contribution arrangements."

[173] Sec. 367(d) (described further in Part B.6) requires use of transfer pricing principles in determining gain to be recognized from a transfer within scope of that section. In addition, special rules may apply in the case of a U.S. taxpayer's transfer or property to a partnership with related foreign partners under sections 704(c) and 721(c) and related regulations.

[174] Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010.

[175] OECD, *Addressing Base Erosion and Profit Shifting*, 2013, available at http://dx.doi.org/10.1787/9789264192744-en; OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports*, October 5, 2015. The findings of the report in 2015 resulted in further guidance that has since been incorporated in the OECD Guidelines.

raised in litigation[176] led to clarification of the definition of intangible property and valuation methods in 2017, as described below.

Definition of intangible property

For purposes of section 482, intangible property is defined by reference to the provision governing gain recognition from outbound transfers of intangible property.[177] That provision includes a list of enumerated items that specifically include goodwill, going-concern value, and workforce-in-place. It clarifies the definition by replacing the residual category of "any similar item" with "any item the value of which is not attributable to tangible property or the services of any individual" and removing certain language to make clear that neither source nor amount of value is relevant in determining whether property in one of the other enumerated categories is within the scope of the definition.[178]

Valuation of intangibles

Section 482 provides that "[f]or purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers."[179] The mandated use of the aggregate basis valuation method in these cases under section 482 is consistent with regulations promulgated prior to the 2017 revision of the statute, which required that synergies created by the interrelated

[176] See, *e.g.*, *Veritas Software Corp. v. Commissioner,* 133 T.C. 297 (Dec. 10, 2009) (including goodwill and going concern value within the definition would "expand" the regulatory definition in effect for the tax year before the Court), *non-acq*., AOD-2010-05, I.R.B. No. 2010-49 (Dec. 6, 2010); *Medtronic Inc. & Consolidated Subs. v. Commissioner*, T.C. Memo. 2016-112 (accepting taxpayer use of the comparable uncontrolled transaction method with few adjustments), vacated and remanded 900 F.3d 610 (8th Cir. 2018) (further findings required to evaluate whether the methodology accepted by the Tax Court was the best method), T.C. Memo. 2022-84 (Tax Court adopts an unspecified method to determine pricing); and *Amazon.com, Inc. v. Commissioner*, 148 T.C. No. 8 (2017), *aff'd* 934 F.3d 976 (9th Cir. 2019) (holding that "workforce in place, going concern value, goodwill, and what trial witnesses described as 'growth options' and corporate 'resources' or 'opportunities'" all fell outside the definition under prior law).

[177] Sec. 367(d)(4). The definition of intangible property was formerly in section 936(h)(3)(B), as amended by section 14221 of Public Law 115-97. That operative definition of intangible property was moved to section 367(d) as a conforming amendment to the repeal of section 936 as deadwood, in the Consolidated Appropriations Act 2018. See Pub. L. No. 115-141, Division U, Title IV, at sec. 401(d)(1)(C) (the repeal of section 936) and sec. 401(d)(1)(D)(viii)(I) (definition of intangible property added to section 367(d)) (March 23, 2018).

[178] Prior to amendment, section 936(h)(3)(B) read as follows: The term "intangible property means any -- (i) patent, invention, formula, process, design, pattern or know-how; (ii) copyright and literary, musical or artistic composition; (iii) trademark, trade name or brand name; (iv) franchise, license or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data; or (vi) any similar item, which has substantial value independent of any individual.

[179] Sec. 482. A contemporaneous expansion of the regulatory authority under section 367 makes clear that the IRS may require the use of aggregate basis valuation and apply the realistic alternative principle in valuation of intangibles transferred in outbound restructuring of U.S. operations.

nature of intangible assets that are transferred in one or more contemporaneous transactions be properly taken into account in order to reach an arm's length result.[180] The approach is also consistent with Tax Court decisions in cases outside of the section 482 context, in which collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate,[181] as well as existing cost-sharing regulations.[182]

Similarly, the realistic alternative principle was explicit in regulations as an underpinning of all transfer pricing methodologies for a transfer of intangibles. "Realistic alternative" was first adopted as an expressly articulated principle in 1994, following IRS defeats in *Bausch & Lomb v. Commissioner,*[183] *Eli Lilly v. Commissioner,*[184] and *G.D. Searle & Co. v. Commissioner*.[185] In determining the income attributable to a taxpayer that participated in a specific transfer of intangibles, the method of valuation chosen must yield results consistent with the economic results from alternative arrangements that were realistically available to that taxpayer. The degree of consistency between anticipated benefits from the transactions under the chosen pricing method and the anticipated benefits of a realistic alternative to the transaction indicates the reliability and appropriateness of the valuation.[186] This principle is predicated on the notion that a taxpayer enters into a particular transaction only if none of its realistic alternatives is economically preferable to the transaction under consideration.

<u>Transfer pricing and challenges to blocked income regulations</u>

Under limited exceptions, the IRS will respect a foreign law proscription that limits cross-border payments when determining whether an arm's length price was paid for cross-

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[180] See Treas. Reg. secs. 1.482-1(f)(2), 1.482-4(c)(1); Treas. Reg. sec. 1.482-1T, which sunset September 14, 2018.

[181] See, *e.g.*, *Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Commissioner*, 25 B.T.A. 281, p. 283 (1932) ("[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).

[182] See Treas. Reg. sec. 1.482-7(g)(2)(iv) (if multiple transactions in connection with a cost-sharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

[183] 933 F.2d 1084 (2d. Cir. 1991).

[184] 856 F.2d 855 (7th Cir. 1988).

[185] 88 T.C. 252 (1987).

[186] See Treas. Reg. sec. 1.482-7(g)(2)(iii) and Examples (1), (2) and (3), thereunder.

border goods or services (the “blocked income regulation”).[187] The validity of the blocked income regulation has been challenged in two recent cases involving aspects of Brazil’s domestic law: *3M Company and Subsidiaries*,[188] and *The Coca Cola Company and Subsidiaries.*[189] In both cases, the taxpayers presented alternative theories based on the Administrative Procedure Act, as well as standards of judicial deference and prior case law on blocked income.[190]

In *3M Company and Subsidiaries*,[191] the Tax Court recently upheld the validity of the regulation in a fully reviewed opinion with nine judges in the majority and eight dissenting. In doing so, the Court analyzed the conditions in the regulation for recognizing a foreign law prohibition. The blocked income regulation recognizes a foreign legal prohibition only if four requirements are met: (1) the foreign law or regulation was publicly promulgated, (2) it applies to both controlled and uncontrolled parties, (3) it prevents the payment in any form, and (4) the taxpayer has exhausted efforts to seek remedy under local law. The Court found that the foreign law prohibition in question failed both the first and second of those four requirements.

In the second case, *The Coca Cola Company and Subsidiaries,* presenting a similar challenge to the blocked income regulation, the Court reserved on the issue[192] after resolving the issues regarding transfer pricing methodology, and subsequently requested further briefing in light of the holding in *3M Company and Subsidiaries*.[193]

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[187] Treas. Reg. sec. 1.482-1(h)(2).

[188] *3M Company and Subs. v Commissioner*, 160 T.C. No. 3 (Feb. 9, 2023) (“*3M Company*”).

[189] *The Coca-Cola Company & Subs. v. Commissioner*, 155 T.C. 145 (Nov. 18, 2020) (“*Coca-Cola*”).

[190] See, *e.g.*, *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972) (in an application of section 482 in a domestic context, a Federal prohibition against banks engaging in insurance business precluded allocation of insurance premium income to the Bank); *Procter & Gamble Co. v. Commissioner*, 961 F.2d 1255 (6th Cir. 1992), *aff’g* 95 T.C. 323 (1990) (recognized Spanish law prohibition).

[191] *3M Company, supra*.

[192] *Coca-Cola, supra,* 155 T.C. at 185.

[193] *The Coca-Cola Company & Subs. v. Commissioner,* T.C. Dkt. No. 31183-15, Dkt. Entry No. 773.

B. Select U.S. Tax Rules Applicable to Foreign Activities of U.S. Taxpayers

1. Subpart F income

Under subpart F, U.S. shareholders of a CFC must include in income their *pro rata* shares of subpart F income, without regard to whether the income is distributed to the shareholders.[194] In effect, U.S. shareholders of a CFC are treated as having received a current distribution of the CFC's subpart F income. With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one jurisdiction to another. Subpart F income consists of foreign base company income,[195] insurance income,[196] and certain income relating to international boycotts and other violations of public policy.[197]

Foreign base company income

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income and foreign base company services income.[198]

Foreign personal holding company income

Foreign personal holding company income ("FPHCI") generally includes income from dividends, interest, royalties, rents, annuities; net gains on certain property transactions; net gains from commodities transactions; net gains from foreign currency transactions; income equivalent to interest; income from notional principal contracts; payments in lieu of dividends; and amounts received under certain personal service contracts.[199]

Several exceptions apply to exclude certain income from FPHCI. For example, FPHCI does not include certain dividends, interest, rents, and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[200] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. Another exception excludes from FPHCI dividends, interest,

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[194] Sec. 951(a).

[195] Secs. 952(a)(2) and 954.

[196] Secs. 952(a)(1) and 953.

[197] Sec. 952(a)(3)-(5).

[198] Sec. 954.

[199] Sec. 954(c)(1)(A)-(H).

[200] Sec. 954(c)(3).

rents, and royalties received or accrued by one CFC from a related CFC to the extent attributable or properly allocable to income of the payor that is not subpart F income.[201]

In addition, there is an "active business" exception for rents and royalties that are derived from an active trade or business conducted by the CFC and not received from a related party.[202] In general, payments by a branch to its owner are disregarded. Thus, in this context, royalty payments by a branch to its CFC owner are disregarded. A branch may include a foreign entity that has elected for U.S. Federal tax purposes to be disregarded as an entity separate from its CFC owner (a "disregarded entity" or "DRE").

<u>Foreign base company sales income</u>

Foreign base company sales income ("FBC sales income") is income derived by a CFC in connection with (1) the purchase of personal property from a related person and its sale to any person; (2) the sale of personal property to any person on behalf of a related person; (3) the purchase of personal property from any person and its sale to a related person; or (4) the purchase of personal property from any person on behalf of a related person. In each of the situations described in items (1) through (4), the property must be both manufactured and sold for use outside the country in which the CFC is organized for the income from its sale to be considered FBC sales income.[203]

There are several exceptions to FBC sales income, including the same country manufacturing exception, same country sales or use exception, and the CFC manufacturing exception. The same country manufacturing exception excludes from FBC sales income any income from the sale of goods manufactured in the country in which the CFC is organized.[204] The same country sales or use exception excludes from FBC sales income any income from the sale of goods for the use, consumption, or disposition in the country in which the CFC is organized.[205]

A second manufacturing exception (*i.e.*, the CFC manufacturing exception), which is set forth in regulations, provides that FBC sales income does not include income from the sale of property that the CFC manufactures, purchases, or sells outside the country in which the CFC is organized if the CFC does not violate the branch rule (discussed below).[206] Manufacturing is defined by physical manufacturing tests such as the substantial transformation test and the

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[201] Sec. 954(c)(6). This exception, colloquially referred to as the CFC look-through rule, applies to taxable years of foreign corporations beginning before January 1, 2026, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

[202] Sec. 954(c)(2)(A).

[203] Sec. 954(d)(1).

[204] Sec. 954(d)(1)(A).

[205] Sec. 954(d)(1)(B).

[206] Treas. Reg. sec. 1.954-3(a)(2).

substantial activity test, as well as nonphysical activities such as the substantial contribution test.[207]

Manufacturing, purchasing, and selling through branches

To qualify for the CFC manufacturing exception, a CFC that manufactures, purchases, or sells outside its country of organization through a branch must satisfy the "branch rule." Under the branch rule, a CFC must show (in effect) that the use of the branch is not to move income from a high-tax jurisdiction to a low-tax jurisdiction. The branch rule provides that, if a CFC manufactures, purchases, or sells through a branch outside its country of organization and the use of the branch has "substantially the same effect" as would the use of a wholly owned subsidiary corporation of the CFC, then the branch and the CFC are treated as separate corporations for purposes of determining FBC sales income of the CFC.

The use of the branch has "substantially the same effect" if a tax rate disparity test is met. The test looks to whether the tax rate of the branch is too low in comparison to that of the CFC. Under the sales branch rule, the test looks to whether the tax rate of the sales branch is too low in comparison to the CFC (where the manufacturing is).[208] Under the manufacturing branch rule, the test looks to whether the tax rate of the CFC (where the sales are) is too low in comparison to the manufacturing branch.[209] If the relevant tax rate (under either test) is too low, then the related income is FBC sales income.

Foreign base company services income

Foreign base company services income ("FBC services income") is income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which (1) are performed for or on behalf of any related person, and (2) are performed outside the country in which the CFC is organized.[210]

FBC services income does not include income derived in connection with the performance of services which are directly related to (1) the sale or exchange by the CFC of property manufactured, produced, grown, or extracted by the CFC and which are performed

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[207] Under the substantial transformation test, a CFC is considered to have manufactured a product if the CFC purchases and substantially transforms personal property prior to its sale, such as processing and converting wood pulp into paper. Treas. Reg. sec. 1.954-3(a)(4)(ii). Under the substantial activity test, a CFC is considered to have manufactured a product through the assembly or conversion of component parts, provided the activities are substantial in nature. Treas. Reg. Sec. sec. 1.954-3(a)(4)(iii). Under the substantial contribution test, a CFC does not have foreign base company income if the CFC engages in certain activities, such as oversight and direction of manufacturing activities, vendor selection, and quality control, that make a substantial contribution to the manufacturing process. Treas. Reg. Sec. sec. 1.954-3(a)(4)(iv).

[208] Treas. Reg. sec. 1.954-3(b)(1)(i)(b).

[209] Treas. Reg. sec. 1.954-3(b)(1)(ii)(b).

[210] Sec. 954(e)(1).

before the time of the sale or exchange, or (2) an offer or effort to sell or exchange such property.[211]

Insurance income

Insurance income subject to current inclusion under subpart F includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization.[212]

Investments in U.S. property

U.S. shareholders also must include their *pro rata* shares of a CFC's untaxed earnings invested in certain items of U.S. property.[213] For this purpose, U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets (such as patents and copyrights) acquired or developed by the CFC for use in the United States.[214] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[215]

Other exceptions

An exception to foreign base company income and insurance income (the "high-tax exception") is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate in effect at the time the income was earned (*e.g.*, for income earned by a CFC in tax year 2020, more than 90 percent of 21 percent, or 18.9 percent).[216]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of a banking or financing business ("active financing income").[217] With respect to income derived in the active conduct of a banking, financing, or similar business,

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[211] Sec. 954(e)(2). Other exceptions apply for income otherwise excluded from subpart F income.

[212] Sec. 953(a) and (e).

[213] Secs. 951(a)(1)(B) and 956.

[214] Sec. 956(c)(1).

[215] Sec. 956(c)(2).

[216] Sec. 954(b)(4). This exception applies to an item of income that would otherwise be included in foreign base company income or insurance income within the meaning of sections 954(a) and 953, respectively. See also Treas. Reg. sec. 1.954-1(d).

[217] Sec. 954(h).

a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business, and other requirements must be met.

For a securities dealer, foreign personal holding company income excludes any interest or dividend (or certain equivalent amounts) from any transaction entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of section 475.[218]

Exclusion of previously taxed earnings and profits

A U.S. shareholder may exclude from its income actual distributions of earnings and profits from a CFC that were previously included in income by the U.S. shareholder under subpart F.[219] Any income inclusion resulting from an investment in U.S. property also may be excluded when such earnings and profits are ultimately distributed.[220]

Basis adjustments

A U.S. shareholder of a CFC generally increases the basis in its CFC stock by the amount of subpart F income inclusions and generally reduces the basis in its CFC stock by the amount of any distributions that are excluded from its income as previously taxed earnings and profits.[221]

2. GILTI

A U.S. shareholder of a CFC also must include in gross income its GILTI. GILTI is the excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return equals the excess of 10 percent of the aggregate of its *pro rata* share of the qualified business asset investment ("QBAI") of each CFC over certain interest expense.[222]

The formula for GILTI is:

$$GILTI = Net\ CFC\ Tested\ Income - [(10\% \times QBAI) - Interest\ Expense]$$

Although a GILTI inclusion is generally treated in the same manner as a subpart F inclusion, GILTI is not subpart F income. GILTI is computed at the U.S.-shareholder level rather than the CFC level, with a U.S. shareholder allowed to offset tested income of its CFCs with tested loss of other CFCs in computing net CFC tested income. When computing tax

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218 Sec. 954(c)(2)(C).

219 Sec. 959(a)(1).

220 Secs. 959(a)(2) and 956.

221 Sec. 961.

222 The interest expense that reduces a U.S. shareholder's net deemed tangible income return is that which is taken into account in determining its net CFC tested income for the taxable year to the extent that the interest income attributable to such interest expense is not taken into account in determining the shareholder's net CFC tested income.

liability associated with GILTI, U.S. shareholders may not take into account certain tax attributes of CFCs with tested loss, such as foreign tax credits and QBAI. In addition, the foreign tax credit limitation is applied separately with respect to GILTI, and no carryovers and carrybacks of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

Net CFC tested income

Net CFC tested income means the excess of the aggregate of the shareholder's *pro rata* share of the tested income of each CFC over the aggregate of its *pro rata* share of the tested loss of each CFC.[223]

The tested income of a CFC is the excess of the gross income of the CFC determined without regard to certain amounts that are exceptions to tested income (referred to in this document as "gross tested income") over deductions (including taxes) properly allocable to such gross tested income. The exceptions to tested income are: (1) any effectively connected income described in section 952(b); (2) any gross income taken into account in determining the CFC's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4);[224] (4) any dividend received from a related person (as defined in section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in section 907(c)(1)).

The tested loss of a CFC means the excess of deductions (including taxes) properly allocable to the CFC's gross tested income over the amount of such gross tested income.

Qualified business asset investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of the CFC's adjusted bases in specified tangible property that is both used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167.[225] The adjusted basis in any property generally must be determined using the alternative depreciation system under section 168(g) as in effect on December 22, 2017.

Specified tangible property means any property used in the production of tested income.[226]

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[223] Sec. 951A(c)(1). *Pro rata* shares are determined under subpart F principles (*i.e.*, the rules of section 951(a)(2) and the regulations thereunder).

[224] See also Treas. Reg. sec. 1.951A-2(c)(1)(iii) and (c)(7) (providing an election to apply the high-tax exception described in section 954(b)(4) to exclude from tested income of a CFC any gross income of such CFC that is subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11).

[225] Sec. 951A(d)(1).

[226] Sec. 951A(d)(2). Specified tangible property does not include property used in the production of tested loss; thus, a CFC with a tested loss in a taxable year does not have QBAI for such taxable year.

Treatment as subpart F income

GILTI inclusions generally are treated in the same manner as amounts included as subpart F income.[227]

Preferential rate on GILTI

The preferential rate on GILTI is achieved by allowing corporations a deduction equal to 50 percent[228] of their GILTI (including the corresponding section 78 gross-up amount).[229]

3. Foreign tax credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed a credit for foreign income taxes they pay. In addition, a domestic corporation is allowed a credit for foreign income taxes paid by a CFC with respect to income included by the corporation as subpart F income and GILTI; such taxes are deemed to have been paid by the domestic corporation for purposes of calculating the foreign tax credit.[230]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. The limit is intended to ensure that the credit mitigates double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[231] The limit is computed by multiplying a taxpayer's total pre-credit U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may (in certain cases) carry back the excess foreign taxes to the previous year or carry forward to one of the succeeding 10 years.[232] No carryback or carryover of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category.

[227] Sec. 951A(f)(1).

[228] For taxable years beginning after December 31, 2025, the deduction for GILTI is reduced to 37.5 percent. Sec. 250(a)(3)(B). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on GILTI is 10.5 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on GILTI rises to 13.125 percent.

[229] Sec. 250(a)(1)(B). Under section 78, a taxpayer claiming the foreign tax credit with respect to foreign-source income generally must include in income the amount of the related foreign taxes paid.

[230] Secs. 901, 903, and 960; see also secs. 1291(g) and 1293(f) (providing, in the PFIC context, coordination with foreign tax credit rules). On January 4, 2022, Treasury published in the Federal Register final regulations relating to the foreign tax credit, including, *inter alia*, modifications to the requirements for determining whether a foreign levy qualifies as a foreign income tax for purposes of section 901 or a tax in lieu of an income tax for purposes of section 903. T.D. 9959, 87 F.R. 276 (Jan. 4, 2022); see also Treas. Reg. secs. 1.901-2 and 1.903-1.

[231] Secs. 901 and 904.

[232] Sec. 904(c).

Deemed-paid taxes

For any subpart F income included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to the aggregate foreign income taxes paid or accrued with respect to such income by the CFC.

For any GILTI included in the gross income of a domestic corporation, the corporation is deemed to have paid foreign taxes equal to 80 percent of the corporation's inclusion percentage multiplied by the aggregate foreign income taxes paid or accrued with respect to tested income (but not tested loss) by each CFC with respect to which the domestic corporation is a U.S. shareholder.[233]

Allocation and apportionment of expenses

To determine its foreign tax credit limitation, a taxpayer must first determine its taxable income from foreign sources by allocating and apportioning deductions between U.S.-source gross income and foreign-source gross income in each limitation category. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[234] However, subject to certain exceptions, deductions for interest expense, stewardship expenses, and research and experimental expenses are apportioned based on certain ratios.[235] For example, interest expense is apportioned based on the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets.[236]

Limitation categories ("baskets")

The foreign tax credit limitation is applied separately to GILTI, foreign branch income,[237] passive category income, and general category income.[238] For this purpose, GILTI and foreign branch income include only income that is not passive category income. Passive category income includes passive income, such as portfolio interest and dividend income, and certain

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[233] Sec. 960(d)(1). The inclusion percentage means, with respect to any domestic corporation, the ratio of such corporation's GILTI divided by the aggregate amount of its pro rata share of the tested income (but not tested loss) of each CFC with respect to which it is a U.S. shareholder. Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

[234] Treas. Reg. sec. 1.861-8(b) and (c) and Temp. Treas. Reg. sec. 1.861-8T(c).

[235] Treas. Reg. sec. 1.861-8 through Temp. Treas. Reg. sec. 1.861-14T and Treas. Reg. sec. 1.861-17 set forth detailed rules relating to the allocation and apportionment of expenses.

[236] Sec. 864(e)(2).

[237] Foreign branch income is defined for this purpose as "the business profits of [the U.S. taxpayer] which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries." Sec. 904(d)(2)(J).

[238] Sec. 904(d); Treas. Reg. sec. 1.904-4(a). The foreign tax credit limitation is also applied separately to certain additional separate categories. See Treas. Reg. sec. 1.904-4(m).

specified types of income.[239] All other income is in the general category. Passive income is treated as general category income if earned by a qualifying financial services entity or if highly taxed (*i.e.*, if the foreign tax rate is determined to exceed the highest tax rate specified in section 1 or 11, as applicable).[240] Dividends (and subpart F inclusions), interest, rents, and royalties received by a U.S. shareholder from a CFC are assigned to the passive category to the extent the payments or inclusions are allocable to passive category income of the CFC.[241] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[242]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[243] Foreign losses from one category first offset foreign-source income from other categories. Any remaining overall foreign loss offsets U.S.-source income. The same principle applies to losses from U.S. sources. In subsequent years, any losses deducted against another category or source of income are recaptured. That is, an equal amount of income from the same category or source that generated a loss in a prior year is recharacterized as income from the other category or source against which the loss was deducted. Foreign-source income in a particular category may be fully recharacterized as income in another category, whereas only up to 50 percent of income from one source in any subsequent year may be recharacterized as income from the other source.

A taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[244]

4. Dividends-received deduction

As discussed above, income earned indirectly through CFCs is taxed either in the year earned (as subpart F income or GILTI) or not at all. Distributions of previously taxed earnings and profits do not constitute dividends.[245]

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[239] Sec. 904(d)(2)(A)(i) and (B).

[240] Sec. 904(d)(2)(B).

[241] Sec. 904(d)(3).

[242] Sec. 904(d)(4).

[243] Sec. 904(f) and (g).

[244] Sec. 909.

[245] Sec. 959(d).

A domestic U.S. shareholder generally is allowed a 100-percent DRD for the foreign-source portion of dividends received from a specified 10-percent owned foreign corporation,[246] provided that certain holding period requirements are satisfied.[247] A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder.[248]

The term "dividend received" is intended to be interpreted broadly, consistent with the meaning of the phrases "amount received as dividends" and "dividends received" under sections 243 and 245, respectively. The DRD is not available for any hybrid dividend.[249]

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD.[250] Further, no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to the U.S.-source portion of any dividend received by a domestic corporation from a qualified 10-percent owned foreign corporation.[251]

5. FDII

Domestic corporations generally are taxed at preferential rates on their FDII.[252] The preferential rate is achieved by allowing corporations a deduction equal to 37.5 percent of their

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[246] Sec. 245A(a). The foreign-source portion of any dividend equals the amount of the dividend multiplied by the percentage of undistributed earnings that are attributable neither to ECI nor to certain dividends received from domestic corporations. Sec. 245A(c).

[247] A domestic corporation is not permitted a DRD in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is satisfied only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10-percent owned foreign corporation at all times during the period. Sec. 246(c)(5).

[248] Sec. 245A(b); see also sec. 951(b) (providing that a domestic corporation is a U.S. shareholder of a foreign corporation if it owns, within the meaning of section 958(a), or is considered as owning by applying the rules of section 958(b), 10 percent or more of the vote or value of the foreign corporation).

[249] A hybrid dividend is an amount received from a CFC for which section 245A(a) would allow a DRD and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States. Sec. 245A(e)(4).

[250] Sec. 245A(d). For purposes of computing the foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must determine its foreign-source taxable income (and entire taxable income) by disregarding: (1) any dividend for which the DRD is taken and (2) any deductions properly allocable or apportioned to (A) income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such foreign corporation, or (B) the stock to the extent income with respect to the stock is other than amounts includible under section 951(a)(1) or 951A(a). Sec. 904(b)(4).

[251] Sec. 245(a)(8).

[252] Sec. 250(a)(1)(A).

FDII.[253] FDII is calculated by multiplying a corporation's "deemed intangible income" by the percentage of its "deduction eligible income" that is derived from serving foreign markets (*i.e.*, "foreign-derived deduction eligible income").[254] A corporation's deemed intangible income equals the excess, if any, of its deduction eligible income over a 10-percent return on its qualified business asset investment ("QBAI").[255] The formula for FDII can be expressed as the following:

$$FDII = [Deduction\ Eligible\ Income - (10\% \times QBAI)] \times \frac{Foreign\ Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

For purposes of computing FDII, a domestic corporation's QBAI is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property[256] used in its trade or business and of a type with respect to which a deduction is allowable under section 167.[257] The adjusted basis in any property generally must be determined using the alternative depreciation system under section 168(g) as in effect on December 22, 2017.

<u>Deduction eligible income and foreign-derived deduction eligible income</u>

Deduction eligible income means, with respect to any domestic corporation, the excess (if any) of the gross income of the corporation determined without regard to certain amounts that are excluded from deduction eligible income (referred to in this document as "gross deduction eligible income") over deductions (including taxes) properly allocable to such gross income.[258]

Foreign-derived deduction eligible income means, with respect to a taxpayer for its taxable year, any deduction eligible income of the taxpayer that is derived in connection with

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[253] For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent. Sec. 250(a)(3)(A). In other words, for taxable years beginning before January 1, 2026, the effective U.S. tax rate (*i.e.*, taking into account the effect of the deduction) on FDII is 13.125 percent. For taxable years beginning after December 31, 2025, the effective U.S. tax rate on FDII is 16.406 percent.

[254] Sec. 250(b)(1).

[255] Sec. 250(b)(2). If the quantity in this formula is negative, deemed intangible income is zero.

[256] Specified tangible property means any tangible property used in the production of deduction eligible income. For this reason, the adjusted basis of tangible depreciable property held by a foreign branch generally is excluded from QBAI because foreign branch income is excluded from gross deduction eligible income.

[257] The definition of QBAI for purposes of computing FDII relies on the definition of QBAI for purposes of computing GILTI under section 951A(d), determined by substituting "deduction eligible income" for "tested income" in section 951A(d)(2) and without regard to whether the corporation is a CFC. Sec. 250(b)(2)(B).

[258] Sec. 250(b)(3)(A). The amounts excluded from deduction eligible income are: (1) subpart F income; (2) GILTI; (3) financial services income; (4) any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; (5) any domestic oil and gas extraction income of the corporation; and (6) any foreign branch income.

(1) property that is sold[259] by the taxpayer to any person who is not a U.S. person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use[260] or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.[261]

Foreign use means any use, consumption, or disposition that is not within the United States.[262] Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or to certain related parties.[263]

Special rules apply with respect to property or services provided to domestic intermediaries[264] and with respect to certain related party transactions.[265]

<u>Taxable income limitation</u>

If the sum of a domestic corporation's FDII and GILTI (including GILTI-attributable section 78 gross-up amounts) exceeds its taxable income determined without regard to this provision, then the amount of FDII and GILTI (including GILTI-attributable section 78 gross-up) for which a deduction is allowed is reduced (but not below zero) by an amount determined by such excess.

6. Gain recognition on outbound transfers of intangible property

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions (*e.g.*, section 351 or 361), nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize gain from the transfer as though the transferor had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity, or disposition of the transferred property in amounts that would have been received either annually over the

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[259] For purposes of determining FDII, the terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Sec. 250(b)(5)(E).

[260] If property is sold by a taxpayer to a person who is not a U.S. person and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.

[261] Sec. 250(b)(4).

[262] Sec. 250(b)(5)(A).

[263] Sec. 250(b)(5)(B) and (C).

[264] Sec. 250(b)(5)(B).

[265] Sec. 250(b)(5)(C).

useful life of the property or upon disposition of the property after the transfer.[266] The appropriate amounts of those imputed payments are determined using transfer-pricing principles.

[266] Sec. 367(d).

C. OECD Two-Pillar Solution

The remainder of this section describes the current status of the OECD project undertaken at the direction of the G-20[267] to address base-erosion and profit shifting ("BEPS") concerns.[268] Although other actions taken in the BEPS project have been adopted by various jurisdictions, including the United States,[269] the OECD final report on how to address problems presented by the digital economy did not provide proposed standards or solutions.[270] Since then, many jurisdictions have taken unilateral action to target certain aspects of digital services provided in general by large technology companies headquartered in the United States, including by imposing unilateral digital services taxes ("DST").

At the urging of the G-20, the OECD continued to work on the project, and proposed blueprints of two pillars as a solution.[271] Following public consultations and further development of those pillars, in October 2021, the Inclusive Framework agreed in principle to the two pillars to address the tax challenges arising from the current state of international taxation of multinational enterprises ("MNEs").[272] Pillar One seeks to revise the principles governing profit allocation among related parties and the amount and kind of contact between a business and a country (*i.e.*, nexus) that is deemed sufficient to justify that country's taxation of that business. Pillar Two seeks to establish a set of rules to enforce a minimum global level of income taxation, addressing structures used by certain MNEs that allow for the shifting of profits into jurisdictions with low or zero tax rates.

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[267] In asking the OECD to develop a response to the economic challenges arising from global digitalization, the G-20 explicitly directed that non-OECD and non-G-20 members be included to ensure global consensus. The resulting body, the OECD/G-20 Inclusive Framework on BEPS, formed in 2015, now has over 140 members. A list of members may be found https://www.oecd.org/tax/beps.

[268] For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[269] Changes to U.S. law enacted in 2017 ameliorated certain aspects of those concerns; the introduction of GILTI and section 245A dividends-received deduction ensure that certain income previously eligible for deferral is now taxed at a minimum level in the year earned or not at all, thus ending most deferral and the "lockout" effect.

[270] OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, October 5, 2015, available at http://www keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report_9789264241046-en.

[271] *Tax Challenges Arising from Digitalisation—Report on the Pillar One Blueprint*, ("Pillar One Blueprint"), available at http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-one-blueprint-beba0634-en htm and *Tax Challenges Arising from Digitalisation—Report on the Pillar Two Blueprint,* ("Pillar Two Blueprint), available at http://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en htm.

[272] OECD (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, OECD, Paris, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021 htm.

1. Pillar One

Under the terms of the Pillar One Blueprint, and all subsequent iterations of the terms of Pillar One, members of the Inclusive Framework agree to rescind existing, and forgo future, digital services taxes and other unilateral measures in return for international consensus regarding the proper allocation of taxing rights with respect to certain profits of multinational enterprises. Such allocation would include ceding taxing rights to market jurisdictions, within a framework that ensures tax certainty for the affected firms within scope of the measure. Since initial publication of the Pillar One Blueprint, the specific components of the proposal have changed with each iteration of the components in documents published by the OECD Secretariat and no consensus document exists. Instead, technical work toward an agreed upon set of model rules and commentary continues. Ultimately, such rules and commentary will serve as the basis for a multilateral instrument to be signed by members for implementation.[273]

The following aspects of Pillar One are addressed below, based on the most current publications: the scope and required nexus, the determination of the residual profit that is allocated to market jurisdictions ("Amount A"), including a proposed market and distribution safe harbor;[274] the allowance for a fixed routine return reportable to market jurisdictions ("Amount B");[275] and the administrative framework to ensure tax certainty by preventing disputes and requiring arbitration in certain cases.[276]

<u>Scope and nexus</u>

To determine whether a taxpayer is within scope of Pillar One (*i.e.*, a "covered entity"), both revenue thresholds and the nature of activities are considered. A covered entity is defined as an entity in a multinational group, or a covered group, where the revenues of the group for the period are greater than €20 billion, and the pre-tax profit margin of the group is greater than 10 percent. Revenues and profits from qualifying extractives and regulated financial services are excluded.[277] In addition, in certain cases, a particular line of business or segment may be treated as a standalone entity that is within scope as a disclosed segment. Although the impetus of the project is concern about the digitalization of the economy, the United States has successfully argued that the digital industry cannot and should not be ring-fenced: that is, the resolution

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[273] OECD (2023) *OECD Secretary-General Tax Report to G20 Finance Ministers and Central Bank Governors, India, February 2023*, OECD, Paris, https://www.oecd.org/g20/topics/international-taxation/oecd-secretary-general-tax-report-g20-finance-ministers-india-february-2023.pdf.

[274] OECD (July 2022) *Progress Report on Amount A of Pillar One*, ("*July Progress Report*") OECD Paris https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf

[275] OECD (2022) *Public Consultation Document Amount B under Pillar One* ("*Amount B Report*"), OECD Paris https://www.oecd.org/tax/beps/public-consultation-document-pillar-one-amount-b-2022.pdf

[276] OECD (2022) *Progress Report on the Administration and Tax Certainty Aspects of Amount A of Pillar One*, ("*Tax Certainty Progress Report*"), OECD Paris https://www.oecd.org/tax/beps/progress-report-on-the-administration-and-tax-certaint-aspects-of-amount-a-of-pillar-one-two-pillar-solution-to-the-tax-challenges-of-the-digitalisation-of-the-economy.htm

[277] *July Progress Report* See pp. 10-12, and Schedules B and C of the report.

should not define a specific subset of companies that are to be treated differently from all other residents in any of the countries within the Inclusive Framework, noting both the continuing trend toward digitalization of all industries, as well as the risk that any such ring-fencing would disproportionately affect U.S. companies.

Together, the revenue thresholds and activity tests are intended to help identify the markets in which the end user is located, both by applying revenue sourcing rules that will vary with the type of service or good as well as particular market revenue thresholds. Revenues are treated as arising in a jurisdiction, or sourced to a jurisdiction, depending on the type of revenue. For example, revenues sourced from location-specific services are sourced to the place of performance of the service. Revenues sourced from online advertising services are sourced to the location of the viewer of the advertisement.[278]

A covered entity or group has nexus with a jurisdiction for the relevant taxable period if its revenues arising in the jurisdiction are equal to or greater than €1 million. However, if the jurisdiction's GDP is less than €40 billion, nexus is satisfied if the covered group's revenues in the jurisdiction are equal to or greater than €250,000.

The expectation is that the thresholds will be based on consolidated financial statements of a multinational group prepared using acceptable financial accounting standards such as Generally Accepted Accounting Principles ("GAAP") and International Financial Reporting Standards ("IFRS").[279]

Amount A: Allocation of the new taxing right

Once scope and nexus have been determined, the portion of residual profits that are to be allocated to a particular market jurisdiction is identified by use of a formula.

Amount A of Pillar One works by reallocating taxing rights on 25 percent of the residual profits (profits in excess of 10 percent of revenues) of covered groups to market jurisdictions, regardless of whether they have a physical presence in such jurisdictions.

The formula for this determination is as follows:

$Q = (P - (R \times 10\%)) \times 25\% \times L/R$,

where –

Q represents the amount of profit allocated to the jurisdiction,

P is the adjusted profit before tax, which is the financial accounting profit or loss of a covered group, adjusted to exclude tax expense or tax income and other items, and

[278] *July Progress Report*, pp. 14-15.

[279] *July Progress Report*, p. 24; Pillar One Blueprint, p. 101.

L/R is the allocation key that represents the ratio of revenues arising in that jurisdiction (or "L") to the revenues of the whole group (or "R"). [280]

Safe harbor for marketing and distribution

After determining the portion of profits that may be eligible to reallocate to a jurisdiction, a marketing and distribution safe harbor may also be available for certain covered groups. If the marketing and distribution safe harbor were to apply, then all or a portion of the amount eligible for allocation under Amount A would be reduced. This adjustment downwards in the profits allocated to the jurisdiction is intended to relieve double taxation that may result if a jurisdiction has already been allocated profits under existing transfer pricing rules. Although the safe harbor has been discussed in terms of marketing and distribution, its calculation is prescribed in terms of determining a fixed rate of return on depreciation and payroll to establish a cap on allocable residual profits more generally (looking at "nonroutine returns" within the jurisdiction) and permits a fixed offset percentage of those returns to be used to offset Amount A. If adequate returns for routine in-country return on depreciation and payroll were already reported in a jurisdiction, or if the notional safe harbor amount already exceeds the amount eligible for allocation under Amount A, then no allocation is to be made to that jurisdiction. The applicable offset percentage is not yet stipulated.

This marketing and distribution safe harbor adjustment is subject to further deliberation at the OECD to address concerns that a pure return on depreciation and payroll approach could result in inappropriate outcomes for routine activities with a low payroll and asset base.[281]

Allocation of elimination profits

The obligation to eliminate double taxation with respect to Amount A is also allocated among those jurisdictions identified as a relieving jurisdiction for a covered group. First, there is a calculation of the elimination profit[282] which is a sum of financial accounting profit or loss in a jurisdiction, adjusted for various items, similar to the concept of Global Anti-Base Erosion income ("Globe income") in Pillar Two. Second, there is an identification of jurisdictions for which the elimination profit equals at least 95 percent of the group's total profit. Third, the jurisdictions are grouped into four tiers, depending on profitability as measured by reference to return on depreciation and payroll in the jurisdiction relative to the overall profitability of the group.[283] Finally, the obligation to eliminate double taxation is allocated to the jurisdictions with the highest return on depreciation and payroll and iteratively to the next highest return on

[280] *July Progress Report*, pp. 15-17.

[281] *July Progress Report*, p. 17, footnote 3.

[282] *July Progress Report*, Schedule I, p. 86-94.

[283] *July Progress Report*, p. 20, paragraph 5. Tier 1 includes the most profitable jurisdictions with return on depreciation and payroll of over 15x of the group's overall return on depreciation and payroll, Tier 2 jurisdictions with return on depreciation and payroll over 1.5x, Tier 3A with return on depreciation and payroll over 0.4x and Tier 3B with return on depreciation and payroll over 0.1x.

depreciation and payroll until the obligation to eliminate double taxation has been fully allocated.[284]

If there are multiple Tier 1 jurisdictions, the jurisdiction with the highest return on depreciation and payroll eliminates double tax through a reduction of taxable profits until that jurisdiction's return on depreciation and payroll is equal to the return on depreciation and payroll of the second jurisdiction. Once the first jurisdiction has the same return on depreciation and payroll as the second jurisdiction, the jurisdictions jointly reduce their return on depreciation and payroll until they are at the level of the third jurisdiction, which then also reduces its return on depreciation and payroll. If double taxation is not fully relieved from Tier 1 profits, Tier 2 jurisdictions (return on depreciation and payroll > 1.5x) are required to relieve double taxation according to the same waterfall. If double taxation is not fully relieved from Tier 1 and Tier 2 jurisdictions, the same then applies to Tier 3A (return on depreciation and payroll > 0.4x) and Tier 3B (return on depreciation and payroll > 0.1x).[285]

Amount B

Sensitivity to the fact that routine transactions are frequent sources of transfer pricing disputes, and that many jurisdictions have limited capacity to handle such disputes, prompted an effort to identify a subset of transactions for which a streamlined approach to intercompany pricing is appropriate, as well as a streamlined pricing methodology and a basis for identifying an arm's-length result where comparable transactions may be unavailable.[286] Amount B is intended to be limited in scope to those transactions that can be reliably evaluated under a streamlined qualitative analysis and a streamlined pricing methodology, the outcomes of which provides results that are consistent with existing transfer-pricing norms.

By limiting Amount B to controlled transactions that involve routine distribution or marketing activities within the distributor or marketer's jurisdiction of residence, for which the distributor does not undertake significant risk, potential exemptions may be appropriate, and the otherwise required necessary analysis of functions may be streamlined. In developing the criteria for determining what transactions should be considered within scope of Amount B, a nonexclusive list of disqualifying activities, such as research and development, manufacturing, financing, or procurement, are under consideration. If an existing advanced pricing agreement covers the transaction for the group, such transaction is excluded from the scope of Amount B.

In addition, the routine nature of the in-scope transactions may allow for streamlined pricing methodology, possibly as a variation of a transactional net margin method. Whether such a streamlined methodology is required or elective remains under consideration, as are questions such as whether the availability of comparable transactions in the local market should be determinative of the pricing methodology permitted. In particular, whether the use of the Amount B methodology will be required even if another method may be determined to be the

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[284] *July Progress Report,* pp. 20-22 and Schedule J.

[285] *July Progress Report*, Schedule J.

[286] *Amount B Report*, Section 1.5 at p. 6 and Section 2.12 at p. 8.

most appropriate method remains an open issue. Work continues with respect to the development of both common benchmarking search criteria and a global dataset.[287]

An implementation framework has not yet been designed for this aspect of Pillar One and could ultimately take the form of either an elective safe harbor or a prescribed standard for determining baseline or distribution activities. The principles to be considered in the development of such framework include the flexibility of existing transfer pricing guidelines requiring a balance of reliability of the methods chosen as well as administrability.

Tax certainty

The need for improved administrative procedures that both prevent disputes as well as offer robust dispute resolutions methods has been a feature of Pillar One since the Blueprint was published in 2020. The scope and type of measures, however, have changed over time.

Tax certainty for Amount A

In late 2022, the OECD described a framework for achieving tax certainty for Amount A as well as issues related to Amount A. With respect to the latter, there is little agreement about what constitutes an issue related to Amount A. In addition to the dispute prevention effect of broad consensus on proper use of specified percentages and formulas to compute Amount A, an administrative framework that includes uniform standards for documentation, currency conversion rules, and filing requirements, may minimize disputes. Different measures of certainty may be provided at different stages of the process of determining Amount A. For example, early confirmation of whether an entity is within scope of Pillar One is expected.[288]

Details regarding the processes anticipated for dispute resolution with respect to Amount A is expected to include mandatory arbitration of the type included in several of the most recent U.S. tax treaties.[289] The extent to which the scope of such arbitration will include related or correlative adjustments that arise as a result of reallocation is uncertain, but under consideration, due to the nature of the new taxing rights as an overlay on traditional transfer pricing rules. The scope of mandatory arbitration expected to be included in a multilateral instrument may need to accommodate existing treaty networks of member jurisdictions, though it is expected to establish a minimum standard. In addition, safe harbors for advanced pricing agreements in place are anticipated, with the expectation that future such agreements would be in conformity with Pillar One principles.

[287] *Amount B Report*, p. 30.

[288] *Tax Certainty Progress Report,* p. 63 and related flowchart.

[289] Bilateral tax treaties of the United States with Belgium, Canada, France, Germany, Japan, Spain, and Switzerland include provisions in which arbitration in certain disputes between competent authorities is mandatory. A table of all bilateral treaties can be found on the IRS website: https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.

Tax certainty for Amount B

In contrast to Amount A, no specific administrative procedures for assuring certainty with respect to Amount B have been proposed, though the general mutual agreement procedures of treaty networks are expected to remain relevant to future disputes. Instead, certainty is expected by incorporation of Amount B principles into transfer pricing guidelines. More importantly, if the methodologies of Amount B are implemented, it is expected that the range of issues or disputes that would arise are expected to be significantly truncated by the streamlined methodologies applicable to Amount B. Because the need for Amount B arose as a result of concern about the number of resource-intensive disputes in jurisdictions that may lack the resources to process such cases efficiently,[290] additional administrative measures may be needed to streamline not only the computational methodology but also the administrative review.

Digital services taxes and other unilateral measures

The final action reports on BEPS failed to resolve the concerns arising from digitalization of the economy that allowed foreign multinational companies without a physical presence in the jurisdiction to earn revenues generated by the digital activity within their jurisdiction, without incurring taxation under existing international norms of taxation. In response, jurisdictions proposed digital services taxes ("DSTs") and other similar unilateral measures to target the revenue generated by such activities. DSTs can target a range of digital activities, including advertising, streaming, the operation of intermediary services (such as online marketplaces), and the collection and sale of user data.

The terms of the OECD's draft multilateral instrument include a definition of digital services taxes and similar measures that are unacceptable, prohibited measures under Pillar One.[291] Such taxes generally are not income taxes, but instead are taxes imposed on market-based criteria in a manner that either explicitly or in practice applies only to foreign and foreign-owned businesses. Value-added taxes, transaction taxes, and anti-abuse measures are generally not within the scope of the prohibited measures. Article 37 requires that all members rescind digital services taxes and similar measures; Article 38 would proscribe allocation of residual profits under Amount A to jurisdictions in violation of Article 37. An administrative process to review whether a levy or tax is in violation of Article 37 is expected. For a list of provisions enacted in various jurisdictions that are expected to be rescinded under the terms of Pillar One, see Appendix A.

2. Pillar Two

In December 2021, the OECD published "Global Anti-Base Erosion Model Rules (Pillar Two)," which provides for a system of taxation based on financial accounts applying a minimum

[290] *Amount B Report,* pp. 28-29, paragraph 43.

[291] OECD (December 2022) *Pillar One—Amount A: Draft Multilateral Convention Provisions on Digital Services Taxes and Other Relevant Similar Measures,* https://www.oecd.org/tax/beps/public-consultation-document-draft-mlc-provisions-on-dsts-and-other-relevant-similar-measures.pdf.

rate of 15 percent on a jurisdictional (country-by-country) basis (the "Model Rules").[292] In March 2022, the OECD published general commentary (and related examples) on the Model Rules,[293] and in December 2022, the OECD published guidance on a transitional safe harbor, a framework for a permanent safe harbor, and transitional penalty relief.[294] Most recently, in February 2023, the OECD published administrative guidance on the Model Rules to address certain specific questions in need of clarification and simplification.[295] For a list of provisions enacted in various jurisdictions adopting at least some aspects of the Model Rules under Pillar Two, see Appendix B.

The Model Rules

Pillar Two seeks to establish a set of rules to enforce a minimum global level of income taxation for MNEs. The intent is to address structures that allow for the shifting of profits into jurisdictions with low or zero tax rates. For each country in which an MNE operates, the Model Rules calculate a top-up tax (which may be zero) on an income tax base that follows from financial accounting principles. This country-by-country approach may limit the tax savings from shifting income between foreign countries. For example, if either a CFC or its branch does not pay an effective rate of tax equal to 15 percent on its income in its country of organization or operation, top-up tax may be imposed by that country or another country under the rules described below.

Companies in scope

The Model Rules apply to MNE groups (and their constituent entities) that have annual revenue of €750 million or more in the consolidated financial statements of the ultimate parent entity in at least two of the four fiscal years immediately preceding the tested fiscal year.[296] An MNE group (or here just MNE) means a collection of entities that are related through ownership

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[292] OECD (2021), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD, Paris https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-theeconomy-global-anti-base-erosion-model-rules-pillar-two htm.

[293] OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition: Inclusive Framework on BEPS*, OECD Publishing, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-thedigitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf. For the related examples, see OECD (2022), *Tax Challenges Arising from the Digitalisation of the Economy –Global Anti-Base Erosion Model Rules (Pillar Two) Examples*, OECD, Paris, https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisationof-the-economy-global-anti-base-erosion-model-rules-pillar-two-examples.pdf.

[294] OECD (2022), *Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)*, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, https://www.oecd.org/tax/beps/safe-harbours-and-penalty-relief-global-anti-base-erosion-rules-pillar-two.pdf.

[295] OECD (2023), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two),* OECD/G20 Inclusive Framework on BEPS, OECD, Paris, www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillar-two.pdf.

[296] Art. 1.1.1 of the Model Rules.

or control such that the assets, liabilities, income, expenses, and cash flows of those entities are included in the consolidated financial statements of the ultimate parent entity with at least one entity (or permanent establishment) that is not located in the jurisdiction of the ultimate parent entity.[297] The ultimate parent entity generally is one that owns (directly or indirectly) a controlling interest in any other entity and in which no other entity owns a controlling interest.[298]

Application of the top-up tax

Top-up tax is due with respect to income in a jurisdiction if book income ("Globe income," discussed below) in the jurisdiction is subject to an effective tax rate ("ETR") of less than 15 percent. The additional top-up tax may be collected first by the source country,[299] second by the residence country of the MNE's ultimate parent entity,[300] third by the residence country of a lower-tier parent entity,[301] and finally by the residence country of any other affiliated entity.[302]

Globe income and the base of the top-up tax

Globe income (or loss) in a country generally is the net income (or loss) determined for an entity in preparing consolidated financial statements of the ultimate parent entity.[303] If Globe income in a country is subject to an ETR of less than 15 percent, then the Globe income is subject to top-up tax.

The ETR for a jurisdiction is equal to the sum of the "adjusted covered taxes" paid in that jurisdiction divided by the net Globe income in that jurisdiction.[304] Adjusted covered taxes are the current tax expenses that have accrued for purposes of calculating that year's financial accounting net income, adjusted for certain deferred tax assets and deferred tax expenses, as well as other differences between tax reporting and financial reporting.[305]

[297] Art. 1.2.1 and 1.2.2 of the Model Rules.

[298] Art. 1.4.1 of the Model Rules.

[299] Under a "qualified domestic minimum top-up tax" ("QDMTT").

[300] Under an "income inclusion rule" ("IIR").

[301] Also under an IIR.

[302] Under an "undertaxed profits rule" ("UTPR").

[303] Art. 3.1.2 of the Model Rules. Several adjustments are made. Art 3.2.1 of the Model Rules.

[304] Art. 5.1.1 of the Model Rules.

[305] Art. 4.1 of the Model Rules.

The base of the top-up tax ("excess profit") generally is Globe income[306] less the substance-based income exclusion for the country.[307] The substance-based income exclusion is five percent of (1) eligible payroll costs in the country, and (2) the carrying value of eligible tangible assets in the country.[308] Thus, for companies that have payroll costs and eligible tangible assets in the relevant country, the amount of top-up tax always is less than the amount of additional tax necessary to increase the ETR on Globe income to 15 percent.

In other words:

Top-up tax = (15% – ETR) x (net Globe income – substance-based income exclusion)[309]

<u>Ordering of the top-up tax</u>

<u>Qualified domestic minimum top-up tax ("QDMTT")</u>

The primary right to tax income (including Globe income) arising in a jurisdiction is with the jurisdiction (the source country) itself. Thus, if in country X an MNE earns Globe income that is subject to an ETR of less than 15 percent, country X has priority in applying a top-up tax. The mechanism for applying that top-up tax (*i.e.*, a top-up tax on domestic income) is the QDMTT.

A natural question arises: why would country X choose to apply a new tax (the QDMTT) instead of simply changing its local corporate tax, whether by increasing the rate (to 15 percent) or expanding the base (to resemble Globe income more closely)? The answer is that the tax base for purposes of determining an MNE's ETR is generally greater than the tax base for purposes of determining the top-up tax. A 15-percent corporate tax that followed the Model Rules in determining its tax base would tend to collect more corporate tax than required under the top-up tax.[310] In other words, the QDMTT represents the only way under Pillar Two for a country to collect in every case the minimum tax liability due with respect to Globe income arising in its jurisdiction.

As described below, if a source country does not impose a QDMTT, the Model Rules allow other countries to collect any top-up tax due with respect to Globe income earned in the source country.

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[306] "Globe" income is an acronym for Global Anti-Base Erosion income (officially, "GloBE" income).

[307] Art. 5.2.3 of the Model Rules.

[308] Art. 5.3 of the Model Rules. Initially, the substance-based income exclusion is set to be 10 percent for eligible payroll costs and eight percent for the carrying value of eligible tangible assets, both phased down to five percent over a 10-year transition period.

[309] See Art. 5.2 of the Model Rules.

[310] A 15-percent corporate tax that followed the base of the top-up tax would be treated in most cases as having an ETR of less than 15 percent.

Income inclusion rule ("IIR")

The secondary right to collect a top-up tax with respect to Globe income earned in a source country is with the jurisdiction of the MNE's ultimate parent entity.[311] This top-up tax is known as the IIR. The mechanism is like other tax regimes ("CFC taxes") that require an ultimate parent entity to pay current tax on the income of controlled foreign corporations ("CFCs"), including Subpart F income and GILTI under U.S. law.[312] In terms of ordering, QDMTTs come before CFC taxes, and CFC taxes come before IIRs (which all come before UTPR, as discussed below).

If the jurisdiction of the ultimate parent entity does not impose an IIR, jurisdictions of any intermediate parent entities (*i.e.*, between the ultimate parent entity and the source country) are allowed to collect under their own IIRs any top-up tax due with respect to Globe income earned in the source country. The IIR has ordering rules to ensure that Globe income in a country is subject to top-up tax exactly once.

Undertaxed profits rule ("UTPR")

The final mechanism providing for the collection of top-up tax is the UTPR. If top-up tax is due, but the source country does not impose a QDMTT and no parent entity is in a jurisdiction imposing an IIR, then countries in which other MNE affiliates are located may collect the top-up tax under a UTPR. Those countries share the top-up tax according to the number of employees in each UTPR jurisdiction and the value of tangible assets in each UTPR jurisdiction.[313]

Tax credits, grants, and the ETR

The ETR on Globe income in a source country may depend on the treatment of certain incentives provided by the country. Grants are treated as additions to Globe income; tax credits are treated as reductions to taxes paid for purposes of calculating the ETR. Certain refundable tax credits (*i.e.*, "qualified refundable tax credits"), however, are treated as grants and, therefore, increase Globe income rather than reduce taxes paid.[314]

For example, consider an MNE in country X with Globe income of 100x, taxes of 20x, and tax credits of 6x. Before accounting for credits, the MNE has an ETR of 20 percent

[311] Art. 2.1.1 to 2.1.3 of the Model Rules.

[312] See generally Part I of this document.

[313] The formula is: UTPR percentage = (50 percent of number of employees in a UTPR jurisdiction / number of employees in all UTPR jurisdictions) + (50 percent of net book value of tangible assets in a UTPR jurisdiction / net book value of tangible assets in all UTPR jurisdictions). Thus, the allocation of UTPR liability is half by number of employees and half by net book value of tangible assets.

[314] Art. 4.1.2(d) of the Model Rules. The Model Rules generally define qualified refundable tax credits as "a refundable tax credit designed in a way such that it must be paid as cash or available as cash equivalents within four years from when … [the MNE] satisfies the conditions for receiving the credit under the laws of the jurisdiction granting the credit."

(20x/100x). Whether the MNE is subject to top-up tax depends on the treatment of the credits. If the tax credits are qualified refundable tax credits, then the ETR is 18.9 percent (20x/106x), well above 15 percent. If the tax credits are not qualified refundable tax credits, however, then the ETR is 14 percent (14x/100x) and the MNE is subject to top-up tax.

III. ECONOMIC ANALYSIS

A. Introduction

1. Global economic environment

In general

Global economic development and changes in how the largest companies conduct their worldwide operations have made U.S. international tax rules increasingly important for policymakers and the private sector. Income growth in developing countries has opened new markets for U.S. MNEs to sell goods and services. Improvements in infrastructure and information technology have lowered the cost of establishing certain business operations, such as manufacturing facilities, abroad.[315] U.S. MNEs have grown increasingly reliant on global supply chains to produce goods more efficiently and to serve foreign markets more effectively.[316] In addition, foreign MNEs have risen in prominence and now compete with U.S. MNEs in many markets. These and other developments have put pressure on U.S. international tax rules to address and accommodate the more complicated ways in which U.S. MNEs organize themselves, serve foreign markets, and structure their production networks. Moreover, as U.S. MNEs generate increasing amounts of income abroad, overall economic positions and investment decisions may become more sensitive to how their foreign-source income is taxed.

Pharmaceutical industry

The pharmaceutical industry engages in a substantial share of total spending in research and development (see Figure 8 in section IV. below), as governments and corporations seek to fight a variety of diseases. Prices for pharmaceutical products continue to rise, as does concern about these increases and their effect on patient access to prescription medicines.[317]

To better understand the economics of the pharmaceutical industry, consider the incentives and pressures. Research and development, costs for new drugs, and the failure, is high; further, a successful drug is often easily imitated. For those reasons, patent protection is important to justify the expense and the risk. Patents give the holder the first-mover advantage, allowing the holder the opportunity to establish strong brand recognition and product loyalty before other corporations enter the market. This, along with the lack of good substitutes for significant new drugs, often give the corporation holding the patent monopoly power. When a

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[315] In 2019, IP-intensive industries accounted for 41 percent of domestic activity or output. For descriptive analysis on the growth of IP-intensive industries, see https://www.uspto.gov/sites/default/files/documents/uspto-ip-us-economy-third-edition.pdf.

[316] For analysis of the growth in foreign value-added in U.S. manufactured products, see Robert Johnson, "Five Facts about Value-Added Exports and Implications for Macroeconomics and Trade Research," *Journal of Economic Perspectives*, vol. 28, no. 2, Spring 2014, pp. 119-142; and Pol Antras and Davin Chor, "Global Value Chains," *Handbook of International Economics*, vol. 5, Elsevier, 2022.

[317] Darius N. Lakdawalla, "Economics of the Pharmaceutical Industry," *Journal of Economic Literature*, vol. 56, no. 2, June 2018, pp. 397-449.

corporation has monopoly power over a patent product, this may lead to prices higher than competitive levels for the patent product. This, in turn, may lead governments to counter with a diverse set of price control mechanisms.[318] On the other hand, when patents expire, generic substitutes often introduce vigorous price competition. The extent to which generics capture market share from the branded original drugs depends on government regulatory policies, the reimbursement policies of healthcare insurers, and the organization of health care provider institutions.[319]

While the Federal government regulates market exclusivity and efficacy within the pharmaceutical industry, the government (especially through Medicare and Medicaid) is also a major customer. This creates a unique situation that sometimes results in the government exercising monopsony power[320] against the patent monopolies. Patent monopolies create incentives for private customers, such as insurance companies, to grow large enough to exercise countervailing market power. The creation of similar but not identical pharmaceutical innovations from other drug manufacturers reinforces this monopsony power, as does the prospect of future competition by generic manufacturers producing identical drugs.[321] All these sources of competition influence price negotiation among public and private customers, and non-price competition like marketing investments.

In industries that depend on creating and using valuable intellectual property, such as the pharmaceutical industry, global operations may involve performing research and development in the United States, transferring the resulting intellectual property to an affiliate in a low-tax jurisdiction, manufacturing through an affiliate in a second jurisdiction, and selling the final product around the world through an affiliate in a third (often again low-tax) jurisdiction.[322]

Whether this arrangement represents a loss of revenue to the United States depends on the transfer price for the intellectual property, the price for the use of the intellectual property abroad, or the amount paid by the foreign affiliate to cover its share of the research and development performed in the United States.

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[318] F.M. Scherer, "The Pharmaceutical Industry," *Handbook of Health Economics*, vol. 1, part B, 2000, pp. 1297-1336.

[319] *Ibid.*

[320] Monopsony power arises when the buyer has the ability to lower the price of a product or service by reducing the quantity they purchase.

[321] F.M. Scherer, "The Pharmaceutical Industry," *Handbook of Health Economics*, vol. 1, part B, 2000, pp. 1297-1336.

[322] See generally Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, and Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the House Committee on Ways and Means Hearing on Transfer Pricing Issues* (JCX-38-10), July 20, 2010. These documents can be found on the Joint Committee on Taxation website at www.jct.gov. See also *Amgen, Inc. & Subs. v. Commissioner*, Dkt. Nos. 16017-21 and 15631-22.

2. Neutrality conditions and their limits

When assessing international tax rules, economists generally start from the position that taxes distort economic activity to the extent that they change economic behavior in ways that result in inefficient levels or patterns of investment.[323] Analysts have settled on a number of general principles when it comes to evaluating whether tax rules promote economic efficiency in the purely domestic, closed-economy context. One general principle is that the pattern of aggregate investment may be more economically efficient if taxes are neutral with respect to the type of investment being made, or more specifically, if effective marginal rates of taxation are the same across investments. In particular, efficiency is enhanced if investments are made based on pre-tax rates of return rather than after-tax rates of return. If effective marginal rates of taxation vary by the type of investment made (*e.g.*, because of different cost recovery rules or investment incentives), that may result in an inefficient allocation of resources and lead to lower levels of production relative to a tax-neutral environment. Specifically, more resources flow to low-taxed sectors than would be the case if taxes were neutral with respect to types of investment, and fewer resources are devoted to more highly taxed sectors. This will generally lead to lower levels of productive efficiency in the economy and reduce national welfare.

In the cross-border, open-economy context, there is significantly less consensus on the principles that should be used to evaluate international tax policy. In the early economic literature, a number of neutrality conditions—the most prominent of which are capital export neutrality and capital import neutrality—were proposed to evaluate whether the international tax system promotes global (and not necessarily national) welfare.[324] The usefulness of these efficiency criteria or general guides to the development of international tax policy has been questioned by a number of commentators. Their validity relies on special (and not necessarily realistic) assumptions concerning the substitutability of domestic and foreign investment and intangible capital.[325] Moreover, some question whether principles used to evaluate whether international tax rules promote global welfare should be used by policymakers when designing their national tax systems, since policymakers may be more concerned with national, as opposed to global, welfare. Nonetheless, these neutrality principles are useful places to start when

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[323] Economists also recognize that taxes can be used to fund government spending and correct for market failures (*i.e.*, instances where the absence of government intervention results in too little or too much of an economic activity). See the discussion in Joint Committee on Taxation, *Economic Growth and Tax Policy* (JCX-47-15), February 2015, pp. 3-5.

[324] The classic reference is Peggy B. Musgrave, *Taxation of Foreign Investment Income: An Economic Analysis*, Johns Hopkins Press, 1963.

[325] For a discussion of the usefulness of the neutrality conditions and the assumptions under which they can be used as efficiency criteria, see American Bar Association Task Force on International Tax Reform, "Report of the ABA Task Force on International Tax Reform," *Tax Law Review*, vol. 59, no. 3, 2005-2006, pp. 652-812; Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," in John W. Diamond and George R. Zodrow (eds.), *Fundamental Tax Reform: Issue, Choices, and Implications*, the MIT Press, 2008, pp. 319-354; and David A. Weisbach, "The Use of Neutralities in International Tax Policy," *National Tax Journal*, vol. 68, no. 3, September 2015, pp. 635-652.

considering how to evaluate the international tax rules that a country adopts, and their limitations may shed light on what other principles or approaches may be more useful for analysis.

Capital export neutrality refers to a condition under which the overall effective tax rate on the return to investments made by a resident in any given country is the same regardless of where the investment is made. In other words, the decision made by a resident to invest at home or abroad is not influenced by tax considerations. As applied to U.S. international tax rules, this condition is generally met if the foreign-source income of U.S. residents is taxed at the same rate as their U.S.-source income.

Capital import neutrality refers to a condition under which the overall effective tax rate on the return to investments made in any given country is the same regardless of the residence of the investor. As applied to U.S. international tax rules, this condition is met if foreign investments made by U.S. investors in any given country face the same overall tax burden as investments made by any other investor in that country. If the other investors are residents in countries that exempt foreign-source income from taxation and the United States exempts the foreign-source income of U.S. residents from taxation, then capital import neutrality is satisfied.

3. Evaluating international tax rules based on behavioral margins

Rather than evaluating tax systems based on whether they satisfy an overarching neutrality condition, recent economic research has focused on how international tax rules affect economic behavior in more specific dimensions of policy relevance, in particular those relating to preserving the income tax base and promoting domestic investment, employment, and growth.

The remainder of Part III surveys the economic literature on (1) the location of reported profits and transfer pricing, and (2) the location of intangible property and returns to intangible investment. These dimensions are interrelated. For example, increasingly common profit-shifting practices include transfer pricing and complex global structuring related to intangible property, in which an MNE effectively underprices intangible capital when "sold" from one of its entities in a high-tax jurisdiction to another of its entities in a low-tax jurisdiction or engages in a series of transactions among subsidiaries that are strategically located in order to reduce the MNE's effective global tax rate.[326]

The remainder of Part III describes how this literature may relate to the level of the U.S. corporate income tax rate, the GILTI inclusion and deduction, the deduction for FDII, and the BEAT for U.S. pharmaceutical companies. Since these provisions were enacted within the last six years and have important differences with tax rules in other countries, studies analyzing the economic effects of these provisions are limited.

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[326] Faith Guvenen, Raymond J. Mataloni, Jr., Dylan G. Rassier, and Kim J. Ruhl. "Offshore Profit Shifting and Aggregate Measurement: Balance of Payments, Foreign Investment, Productivity, and the Labor Share," *American Economic Review*, vol. 112, no. 6, 2022, pp. 1848-1884.

B. Location of Reported Profits and Transfer Pricing

1. Background

As reflected in the OECD BEPS Project, policymakers are concerned that the location of profits derived from the sale of goods and services is not aligned with where the value underlying those goods and services was generated, thus reducing tax revenue. For example, in the United States, there has been a concern that a large share of U.S. corporate profits is located in low-tax jurisdictions where corporations have relatively little employment and tangible investment, even though the innovations generating those profits may have been developed in the United States.[327] Some commentators have noted that the geographic distribution of profits, even if legal, is at least partly artificial to the extent that it does not reflect where the real economic activity generating those profits is located.[328] Others have disputed this characterization and also contended that requiring a closer link between the location of profits and the location of real economic activity will cause U.S. corporations to shift U.S. employment and investment to low-tax jurisdictions and result in economic distortions.[329]

2. Location of reported profits

There is a large empirical literature analyzing the general question of how responsive the location of profits is to differences in tax rates across countries (without taking a position on where taxable income should be located as an economic matter). One survey of the literature finds that a one percentage-point reduction in the tax rate of a host country is predicted to lead to a 0.8 percent increase in the profits reported by a foreign subsidiary located in that country.[330] However, a number of the studies reviewed in the survey are limited in that they (1) rely on financial statement data rather than tax data, and (2) exclude from their analysis, because of data

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[327] For a discussion of the issues, see Gabriel Zucman, "Taxing across Borders: Tracking Personal Wealth and Corporate Profits," *Journal of Economic Perspectives*, vol. 28, no. 4, Fall 2014, pp. 121-148; and James R. Hines Jr., "Treasure Islands," *Journal of Economic Perspectives*, vol. 24, no 4, Fall 2010, pp. 103-126. An analysis of certain tax planning strategies MNEs may use in some cases to shift income to low-tax jurisdictions can be found in Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[328] See Kimberly A. Clausing, "Profit Shifting before and after the Tax Cuts and Jobs Act," *National Tax Journal*, vol. 73, no. 4, December 2020, pp. 1233-1266.

[329] For a discussion on the possible limits of using the location of employment and investment as the basis for assessing where income is earned, see James R. Hines Jr., "Income Misattribution under Formula Apportionment," *European Economic Review*, vol. 54, no. 2, 2009, pp. 108-120. Some researchers have argued that methodological issues have caused estimates of profit shifting out of the United States to be overstated. See the discussion in Kimberly A. Clausing, "Profit Shifting before and after the Tax Cuts and Jobs Act," *National Tax Journal*, vol. 73, no. 4, December 2020, pp. 1233-1266.

[330] Josh H. Heckemeyer and Michael Overesch, "Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels." *Canadian Journal of Economics*, vol. 50, no. 4, November 2017, pp. 965-994. The methodology used in this paper was extended and updated in Sebastian Beer, Ruud de Mooij, and Li Liu, "International Corporate Tax Avoidance: A Review of the Channels, Magnitudes, and Blind Spots," *Journal of Economic Surveys*, vol. 34, no. 3, July 2020, pp. 660-688. This survey reports a slightly larger average estimate.

availability, a significant number of low-tax jurisdictions. One paper analyzing tax return data from all U.S. CFCs reports a generally larger response of the location of profits to tax rate differentials, with the responsiveness dependent on the level of the host country tax rate.[331] The paper finds that a change in the host country tax rate from five percent to four percent results in a 4.7 percent increase in reported profits, while a change from 30 percent to 29 percent results in a 0.7 percent increase in reported profits.

Puerto Rico is an example of a low-tax jurisdiction that is attractive to shift reported taxable income from the United States. Prior to the repeal of section 936[332] in 1996, the favorable tax treatment of Puerto Rican affiliates of U.S. corporations resulted from a combination of Puerto Rican and United States law.[333] Using corporate tax return data on section 936 companies in manufacturing, one study develops a structural econometric model of the joint decisions regarding investment and income shifting on U.S. activity in Puerto Rico.[334] The results suggest that the income shifting advantages are the predominant reason for U.S. investment in Puerto Rico. After the repeal of section 936, many papers focus on the effects of the repeal on the manufacturing industry in Puerto Rico. Despite the use of various data and methodologies, these papers generally find a consistent negative effect of the repeal of section 936 on the number of establishments, employment, wages, and exports in the manufacturing industry of Puerto Rico.[335]

3. Transfer pricing

Another set of papers has analyzed potential channels for profit shifting, particularly the channels through which transfer prices are set. These papers examine the extent to which transfer prices, which should reflect arm's length prices, may deviate from arm's length prices. These studies generally rely on import and export price data collected by government agencies and compare prices charged to related and unrelated parties for similar products (although the related-party price data is sometimes estimated and not actually observed). An early study based on aggregate U.S. import and export price data (*i.e.*, across all companies for specific products) finds that a one percentage-point reduction in the tax rate of a destination country is associated

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[331] Tim Dowd, Paul Landefeld, and Anne Moore, "Profit Shifting of U.S. Multinationals," *Journal of Public Economics*, vol. 148, no. 1, April 2017, pp. 1-13.

[332] In general, prior to 1996 section 936 allowed subsidiaries of U.S. firms operating in Puerto Rico to pay no federal taxes on their Puerto Rican profits, even if those profits were returned to the United States.

[333] Zoltan M. Mihaly, "Tax Advantages of Doing Business in Puerto Rico," *Stanford Law Review*, vol. 16, no. 1, December 1963, pp. 75-106.

[334] Harry Grubert and Joel Slemrod, "The Effect of Taxes on Investment and Income Shifting to Puerto Rico," *The Review of Economics and Statistics*, vol. 80, no. 3, August 1998, pp. 365-373.

[335] Wilfredo Toledo, "Foreign Direct Investment and Manufacturing Growth: The Case of Tax Incentives in Puerto Rico," *Modern Economy*, vol. 8, 2017, pp. 272-281; and Zadia M. Feliciano and Andrew Green, "U.S. Multinationals in Puerto Rico and the Repeal of Section 936 Tax Exemption for U.S. Corporations," NBER Working Paper 23681, August 2017. The data and methodology used in this paper was extended and updated in Zadia M. Feliciano, "IRS Section 936 and the Decline of Puerto Rico's Manufacturing," *Centro Journal*, vol. 30, no. 3, Fall 2018, pp. 30-42.

with a 1.8 percent decrease in the related-party export price (relative to prices charged to unrelated parties), and that a one percentage-point reduction in the tax rate of an origin country is associated with a two percent increase in the related-party import price charged by that country/paid to that country (relative to prices charged to unrelated parties).[336] A more recent study using firm-level Danish export data finds that a one percentage-point reduction in the tax rate of a low-tax country is associated with a 0.6 percent decrease in export prices of MNEs with affiliates in that country (relative to prices charged to unrelated parties).[337] Using French tax and trade data, some economists find that the effect, with respect to the price of exported goods, mainly arises in exports to particularly low-tax jurisdictions and not elsewhere.[338] In contrast, another recent study relying on firm-level tax and trade data from the United Kingdom finds that a one percentage-point increase in the tax rate of a destination country results in a three percent decrease in export prices charged to related parties in the United Kingdom (relative to unrelated parties), and that the decrease became 4.5 percent after the United Kingdom adopted a territorial tax system.[339] The difference in results is not necessarily a reflection of differences in the tax sensitivity of transfer prices across countries, but that the methodological approach across these papers varies.

4. Implications for the effect of U.S. international tax rules on U.S. pharmaceutical companies

CFC rules have been used to address profit shifting by reducing the tax advantage of locating profits in low-tax jurisdictions. One paper examining European MNEs finds that home-country CFC rules lowered profits reported in low-tax host jurisdictions and increased profits in higher-tax jurisdictions. In addition, the paper estimates that half of the resulting increase in the tax base accrues to the home country enforcing the CFC rule (with the other half accruing to other higher-tax jurisdictions as income is shifted out of low-tax jurisdictions).[340]

In the U.S. context, the GILTI provisions (including the GILTI deduction) were intended, in part, to address potential base erosion that would result from the 100-percent DRD, and Joint

[336] Kimberly A. Clausing, "Tax-Motivated Transfer Pricing and U.S. Intrafirm Trade Prices," *Journal of Public Economics*, vol. 87, nos. 9-10, September 2003, pp. 2207-2223.

[337] Anca D. Cristea and Daniel X. Nguyen, "Transfer Pricing by Multinational Firms: New Evidence from Foreign Firm Ownerships," *American Economic Journal: Economic Policy*, vol. 8, no. 3, August 2016, pp. 170-202.

[338] Ronald B. Davies, Julien Martin, Mathieu Parenti, and Farid Toubal, "Knocking on Tax Haven's Door: Multinational Firms and Transfer Pricing," *The Review of Economics and Statistics*, vol. 100, no. 1, March 2018, pp. 120-134.

[339] Li Liu, Tim Schmidt-Eisenlohr, and Dongxian Guo, "International Transfer Pricing and Tax Avoidance: Evidence from Linked Trade-Tax Statistics in the United Kingdom," *The Review of Economics and Statistics*, vol. 102, no. 4, October 2020, pp. 766-778.

[340] Sarah Clifford, "Taxing Multinationals beyond Borders: Financial and Locational Responses to CFC Rules," *Journal of Public Economics*, vol. 173, no. 1, May 2019, pp. 44-71.

Committee staff estimated the GILTI provisions to raise tax revenue.[341] Using quarterly data from Standard and Poor's Compustat, a recent study examines MNE's responses to Public Law 115-97 ("the 2017 legislation") and finds that spending and investment behavior depends on liquidity, investment opportunities, and borrowing costs. In particular, the study finds that MNEs with high foreign cash and most likely to be subject to tax under the GILTI provisions increased their foreign but not domestic capital expenditures. The fact that the GILTI inclusion is reduced by a return on the basis of foreign tangible assets may provide U.S. MNEs with an incentive to invest in foreign tangible assets instead of domestic tangible assets.[342] In addition, a study that also uses Compustat data finds that the 2017 legislation, mainly the decrease in the U.S. corporate tax rate from 35 percent to 21 percent, reduced the tax burden for public U.S. corporations' domestic, not foreign, earnings, resulting in equal tax relief to purely domestic U.S. corporations and U.S. MNEs. [343] The authors argue that this equalized burden likely reduces the incentive to shift earnings to foreign jurisdictions relative to years before 2018.[344]

Using a combination of survey data, tax data, and firm financial statements, another recent study finds evidence that, consistent with incentives introduced in the law, U.S. MNEs book a larger share of their profits in the United States after 2017. The share of profits booked abroad has decreased by about 3-5 percentage points, to about 27 percent for all U.S. MNEs, or between 10 and 16 percent for all U.S. MNEs.[345] The authors argue that the lower U.S. corporate rate and current inclusion of GILTI reduce the incentives for U.S. MNEs to book profits in tax havens, but the move to a territorial system increases the incentives to shift income to low-tax countries. In addition to investment in the United States by U.S. MNEs, one study finds that while foreign MNEs did not increase their real property investments after 2017, they did increase the earnings they retained in the United States. [346]

While the research on the effect of tax differentials on transfer prices has largely focused on inbound payments, one implication of the research is that tax differentials affect how transfer prices are set. To the extent that this is true, and to the extent that this interpretation of the research applies to outbound payments as well (*i.e.*, tax rate differentials may create an incentive to price outbound related-party payments at higher than arm's length prices if the payee

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[341] Joint Committee on Taxation, *Estimated Budget Effects of the Conference Agreement for H.R. 1, the "Tax Cuts and Jobs Act"* (JCX-67-17), December 2017. This document can be found on the Joint Committee on Taxation website at www.jct.gov.

[342] Brooke D. Beyer, Jimmy F. Downes, Mollie E. Mathis, & Eric T. Rapley, "U.S. Multinational Companies' Payout and Investment Decisions in Response to International Tax Provisions of the Tax Cuts and Jobs Act of 2017," *Journal of the American Taxation Association*, January 2022.

[343] Scott D. Dyreng, Fabio B. Gaertner, Jeffrey L. Hoopes, and Mary E. Vernon, "The Effect of U.S. Tax Reform on the Taxation of U.S. Firms; Domestic and Foreign Earnings," January 2023, forthcoming.

[344] *Ibid.*

[345] Javier Garcia-Bernardo, Petr Jansky, & Gabriel Zucman, "Did the Tax Cuts and Jobs Act Reduce Profit Shifting by US Multinational Companies?" NBER Working Paper Series, May 2022.

[346] Matheson, Thornton, Alexander Klemm, Laura Power, and Thomas Brosy, "The Impact of the Tax Cuts and Jobs Act on Foreign Investment in the United States," *IMF* Working Paper 22/79, 2022.

jurisdiction is lower tax than the payor jurisdiction), existing economic research may offer some support for one possible motivation for enacting the BEAT (which limits the ability of foreign corporations from taking advantage of certain deductions).[347] However, these results generally have limited applicability to the BEAT because (1) base erosion payments under the BEAT are not affected by the home-country tax rate of the related party, and (2) the studies focused on the pricing of goods.

Changes in the 2017 legislation generally reduced the incentive to book profits abroad, including (1) the decrease in the U.S. corporate rate from 35 percent to 21 percent, (2) taxation of GILTI, and (3) the taxation of base erosion payments to foreign affiliates. One recent survey of annual reports filed with the U.S. Securities and Exchange commission by a group of 15 large pharmaceutical companies argues that the foreign share of worldwide profits has stayed roughly constant since 2015 (around 75 percent), with a relatively large increase in 2020 (to 82 percent) and followed by a relatively large decline in 2021 (to 63 percent).[348] The incentive to keep profits out of the United States while reduced, was not eliminated; blending of losses, taxes, and QBAI in GILTI continues to shield some low tax income.

[347] Committee Recommendations as Submitted to the Committee on the Budget Pursuant to H. Con. Res. 71, S. Prt. 115-20, p. 396.

[348] Martin A. Sullivan. "Pharma Profits Are Mostly Overseas, But Only Amgen Is In Tax Court," *Tax Notes International*, vol. 109, March 2023.

C. Location of Intangible Property and the Returns to Intangible Investment

1. Background

The taxation of income derived from intangible property has become a central issue in international tax policy discussions for at least two reasons. First, the returns to intangible property are a particularly mobile source of income and account for a significant share of profits reported by MNEs.[349] Second, the research activity associated with the development of intangible property is an important driver of innovation and economic growth.[350] In the U.S. context, part of the policy motivation for enacting the deduction for FDII was to encourage the location of more intangible income, and potentially some of the activity giving rise to that intangible income, in the United States, and make the U.S. tax system more neutral with respect to where U.S. MNEs locate intangible property and income (under the view that the United States was a less favorable location under prior law).[351]

2. Location of intangible property

There is evidence that the location of certain intangible property within MNEs is sensitive to tax policy. A series of papers studying European MNEs and their intangible property holdings finds that they tend to hold more intangible property in affiliates located in lower-tax jurisdictions and have fewer patent filings in affiliates located in higher-tax jurisdictions.[352] However, these papers do not answer the question of whether lower tax rates result in increased overall levels of intangible property in the MNE group. In contrast to these findings on intangible property in European MNEs, one paper studying corporations listed in the Standard and Poor's 500 Index finds that U.S. marginal tax rates have no significant effect on where U.S. trademarks are held, and that offshore trademark ownership is influenced more by foreign

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[349] Harry Grubert, "Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location," *National Tax Journal*, vol. 56, no. 1, pt. 2, March 2003, pp. 221-242. These profits may also be a source of wage growth. One paper examining surplus profits arising from patent allowances finds that workers capture, in the form of higher earnings, approximately 30 cents of every dollar of surplus generated from the patent. See Patrick Kline, Neviana Petkova, Heidi Williams, and Owen Zidar, "Who Profits from Patents? Rent-Sharing at Innovative Firms," *Quarterly Journal of Economics*, vol. 134, no. 3, August 2019, pp. 1343-1404.

[350] The benefits of U.S. research activity are largely localized but may also be diffused internationally. One study finds that the median U.S. multinational firm realizes 20 percent of the return to its U.S. research and development investment abroad. See L. Kamran Bili and Eduardo Morales, "Innovation in the Global Firm," *The Journal of Political Economy*, vol. 128, no. 4, April 2020. Note that intangible property may include property, such as certain marketing intangibles, that do not result from scientific research.

[351] Committee Recommendations as Submitted to the Committee on the Budget Pursuant to H. Con. Res. 71, S. Prt. 115-20, p. 375.

[352] Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets within Multinational Firms," *Journal of Public Economics*, vol. 95, nos. 7-8, August 2011, pp. 691-707; and Tom Karkinsky and Nadine Riedel, "Corporate Taxation and the Choice of Patent Location within Multinational Firms," *Journal of International Economics*, vol. 88, no. 1, September 2012, pp. 176-185.

activities than tax rates.[353] In particular, for trademarks held offshore, host-country taxes have a significant effect on location choice only if U.S. CFC rules do not apply. The U.S. trademark locations of European MNEs, however, are more responsive to U.S tax rates.

3. Returns to intangible investment (patent boxes and research activity)

From the perspective of investment, employment, and economic growth, the research activities associated with intangible property are potentially more important than where the intangible property is located. Several countries have adopted "patent boxes" that offer preferential treatment to income generated from patents that are located in those countries, and research on patent boxes may offer insight into whether the location of intangible property is accompanied by increased research activities. In contrast to some of the overarching results in the papers described in the previous section, one paper has found that patent boxes have a small effect on patent transfers (with more noticeable effects for patent boxes that do not have any local development requirement), but have no effect on research spending and patented inventions in the countries offering patent boxes.[354] Another paper predicts that patent boxes may encourage the location of new patents but lead to significant losses in tax revenue.[355] One survey of economic research on policies to promote innovation finds that, from a tax policy perspective, research credits are relatively effective tools to promote research spending, but the cost of patent boxes outweighs their benefits.[356]

Some of the research surveyed above was conducted prior to the OECD agreement on the Modified Nexus Approach for patent boxes, which requires a link between research spending and the intangible property underlying the patent-related income receiving the tax benefit (*i.e.*, nexus). One study analyzes how a patent box in one country affects research and development ("R&D") activity in other countries and how that relationship depends on the requirement for nexus and relocation costs of R&D activity.[357] Using MNE affiliate-level data, the study finds that patent box regimes that do not require nexus (*i.e.*, has low relocation costs of R&D activity) exert positive cross-border effects on R&D activity. Therefore, existing economic research suggests that a jurisdiction that sets preferential rates on patent-related income alone may not increase research activity in that jurisdiction.

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[353] Jost H. Heckemeyer, Pia Olligs, Michael Overesch, "'Home Sweet Home' Versus International Tax Planning: Where Do Multinational Firms Hold Their U.S. Trademarks?" *National Tax Journal*, vol. 71, no. 3, September 2018, pp. 485-520.

[354] Fabian Gaessler, Bronwyn H. Hall, and Dietmar Harhoff, "Should There Be Lower Taxes on Patent Income?" *Research Policy*, vol. 50, no. 1, January 2021, pp. 104-129.

[355] Rachel Griffith, Helen Miller, and Martin O'Connell, "Ownership of Intellectual Property and Corporate Taxation," *Journal of Public Economics*, vol. 112, no. 1, April 2014, pp. 12-23.

[356] Nicholas Bloom, John Van Reenen, and Heidi Williams, "A Toolkit of Policies to Promote Innovation," *Journal of Economic Perspectives*, vol. 33, no. 3, Summer 2019, pp. 163-184.

[357] Thomas Schwab and Maximilian Todtenhaupt. "Thinking Outside the Box: The Cross-border Effect of Tax Cuts on R&D," *Journal of Public Economics*, vol. 204, December 2021.

4. Implications for the effect of U.S. international tax rules on U.S. pharmaceutical companies

To the extent that (1) taxes influence the location of intangible property and (2) the location of intangible income follows the location of intangible property, preferential rates on intangible income offered by a country may result in more intangible income being located in that country. The application of this result to the deduction for FDII (paired with the deduction for GILTI) is unclear because the calculation of deemed intangible income is formulaic and not based on items of income tied to intangible property. In addition, only a portion of deemed intangible income, depending on foreign income derived by the U.S. corporation, benefits from the FDII deduction, while the taxes studied in the economics literature on the effect of taxation on the location of intangible property generally apply to all intangible-related income (and sometimes all income) earned by the company.

Thus far, there is no causal research on how the deduction for FDII and GILTI effects U.S. pharmaceutical companies. There is a descriptive study that documents the changing nature of outbound royalties from Ireland for U.S. pharmaceutical and information and communication technology companies. The study finds that from 2016 to 2020 outbound royalty payments by U.S. pharmaceutical MNEs to related parties in Ireland have reduced from €24 billion to €14 billion. Over the same time period, outbound royalty payments linked to U.S. information and communication technology MNEs in Ireland have risen from €28 billion to €57 billion.[358] This analysis focuses on the following events during this time period: (1) the one-time transition tax on pre-2018 profits of U.S. MNEs which had benefitted from deferred taxation, (2) the U.S. tax due on what is deemed to be GILTI, (3) the relief provided by the United States for FDII, and (4) changes to the information and communication technology sector's licensing arrangements for the use of their intellectual property by their international operations.

[358] Seamus Coffey, "The changing nature of outbound royalties from Ireland and their impact on the taxation of the profits of US multinationals," *Ireland's Department of Finance*, June 14, 2021, available at https://www.gov.ie/en/publication/fbe28-the-changing-nature-of-outbound-royalties-from-ireland-and-their-impact-on-the-taxation-of-the-profits-of-us-multinationals-may-2021/. This paper studies the time period 2016 to 2020, because pre-existing double Irish structures ended by January 2020. In general, a double Irish structure consists of a corporation setting up two subsidiaries in Ireland: a holding and operating Irish company. The holding company registers in a tax haven, which allows it to avoid paying taxes on its profits.

IV. TRENDS IN U.S. PHARMACEUTICAL FOREIGN- AND U.S.-SOURCE INCOME AND ACTIVITIES

The staff of the Joint Committee ("Joint Committee staff") has examined preliminary aggregate taxpayer data from tax year 2014 to tax year 2020 to provide information on the tax positions of U.S. pharmaceutical corporations.

A. Worldwide and U.S. GAAP Average Tax Rates for Large Corporations

Using generally accepted accounting principles ("GAAP"), Table 1 reports the worldwide and U.S. average tax rates ("ATRs") for three different groups of large, publicly traded corporations: (1) all corporations (subject to the sample limitations below), (2) manufacturing corporations (two-digit NAICS codes 31 to 33, excluding pharmaceutical corporations), and (3) pharmaceutical corporations (four-digit NAICS code of 3254).[359] The data underlying the tax rate calculation are drawn from the Compustat database, which is populated from financial statements (*e.g.,* Form 10-K) filed with the Securities and Exchange Commission ("SEC").[360] [361] The sample is limited to U.S. headquartered corporations that appeared in the Compustat database in each year from 2014 to 2020 (*i.e.,* a balanced panel), had positive pre-tax income from foreign operations in at least one of those years, and had at least $100 million in assets in 2016. The ATRs presented here are weighted by income and calculated using corporations that report positive pre-tax income. The worldwide ATR is calculated as taxes paid divided by pre-tax income. The domestic rate is calculated as Federal income taxes paid divided by domestic pre-tax income. Each of these items are reported on the income statement as part of Form 10-K. Tax years 2017 and 2018 are excluded from the table for two reasons. First, income and deductions were shifted between these two years in response to the passage of Public Law 115-97.[362] Second, many corporations had section 965 repatriation tax liability in these years. However, because that liability was generated from income earned in prior years, it is inconsistent with an ATR calculation, which measures the average tax rate paid on income earned in a given year.[363] If it were possible to reallocate the section 965 liability to

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[359] The three categories of corporations include 206, 74, and 11 corporations, respectively.

[360] Standard and Poor's (S&P). 2023. Compustat-Capital IQ. S&P Global Market Intelligence. https://wrds-www.wharton.upenn.edu/pages/about/data-vendors/sp-global-market-intelligence/.

[361] Tax return data lack comprehensive information on worldwide income, which prevents the estimation of worldwide ATRs. The Joint Committee staff presents financial statement ATRs here, which are common in the accounting, economics, and finance literatures.

[362] Tim Dowd, Chris Giosa, and Thomas Willingham, "Corporate Behavioral Responses to the TCJA for Tax Years 2017-2018," *National Tax Journal*, vol. 73, no. 4, December 2018, pp. 1109-1134.

[363] Section 965 imposed a one-time transition tax on a U.S. shareholder's pro-rata share of certain undistributed and previously untaxed post-1986 foreign earnings and profits earned by a specified foreign corporation at the end of such specified foreign corporation's last taxable year beginning before January 1, 2018. The transition tax constituted an additional tax expense for financial reporting that increased effective tax rates reported on Form 10-K in 2017 and 2018 (in some cases by more than 50 percent) pursuant to the Financial Accounting Standard Board's Accounting Standards Codification 740.

the income that generated the liability (*i.e.*, in prior years going back to 1986), it would change the ATRs of corporations in the 2014 to 2016 period in the table.[364]

Table 1.—Worldwide ATRs for Large Corporations

	Worldwide ATRs		**Domestic ATRs**	
Corporations	2014-2016	2019-2020	2014-2016	2019-2020
All	27.9	16.7	25.7	11.3
Manufacturing	24.1	17.9	25.7	15.4
Pharmaceutical	19.6	11.6	27.0	15.7

[364] Prior to Public Law 115-97, Financial Accounting Standards Board Accounting Standards Codification 740 allowed U.S. corporations to assert that their investment in a foreign subsidiary was permanent and that the foreign earnings would be indefinitely reinvested. Corporations that made this assertion recorded a permanent reduction in their effective tax rate equal to the residual U.S. federal income tax. Corporations that did not make this assertion did not reduce their effective tax rate. Rather, such corporations recorded a deferred tax liability to indicate to investors that they anticipated recognizing U.S. tax on such amounts in a future year. Consequently, corporations that made an indefinite reinvestment assertion recognized a tax liability in 2017 or 2018 pursuant to the section 965 repatriation tax and were required to report an increase of their effective tax rate (because such corporations never accounted for the tax in their financial statements). Conversely, corporations that did not make an indefinite investment reduced their reported deferred tax liability, resulting in a decrease in their effective tax rate in 2017 or 2018 (because such corporations recorded a higher tax rate on such amounts for financial reporting in prior years than the section 965 repatriation tax actually imposed).

Reporting of the repatriation tax liability in 2017 and 2018 varied. Many corporations did not provide sufficient detail on Form 10-K to isolate the repatriation tax liability because they netted it with other items (for example, the research and development credit). In other cases, the reported repatriation tax included the reversal of previously established deferred tax liabilities on unremitted earnings (as noted above, a reduction of the effective tax rate).

Several conclusions may be inferred from Table 1. First, the average worldwide ATRs for all large corporations, manufacturing corporations, and pharmaceutical corporations declined by seven to nine percentage points after the enactment of Public Law 115-97. Second, each of these groups of corporations experienced larger declines in domestic ATRs, ranging from 10 to 14 percentage points on average. This decline is consistent with the reduction in the top statutory corporate tax rate from 35 percent to 21 percent, as enacted in Public Law 115-97. Third, pharmaceutical corporations on average had lower worldwide ATRs and higher domestic ATRs than manufacturing and all corporations, before and after the passage of Public Law 115-97.

B. Corporate Tax Return Information for Large Pharmaceutical Companies

This section focuses on information reported from corporate tax returns (*e.g.,* Form 1120). In the figures below reporting shares, the Joint Committee staff compare various measures of profit, income, and deductions against gross income. Because a good estimate of revenue (*i.e.*, sales or turnover) is not available from the tax data, the Joint Committee staff present the figures against a close (albeit imperfect) proxy: gross income. To avoid confounding the inferences from those share graphs with legislated changes in the tax of certain income items, gross income is defined as total income reported on line 11 of Form 1120, plus cost of goods sold reported on line 2, less section 965 income and GILTI income reported on Schedule C of Form 1120.[365] The reported shares are income weighted average shares.

The full sample is a balanced panel and includes all corporations that (1) reported at least $100 million in assets in 2016, as reported on line 12a of Schedule M3 of Form 1120, (2) were not foreign owned, and (3) had at least one controlled foreign corporation in 2016. In the figures below, the group "large pharmaceutical" comprises the 21 largest pharmaceutical corporations in terms of total worldwide assets, as reported on Schedule M3 in 2016. The group "large manufacturing" is a weighted set of 21 manufacturing corporations (excluding pharmaceutical corporations). The Joint Committee staff uses a combination of asset and return on asset to weight the different groups in these figures to represent as closely as possible similar sized corporations (as measured by assets and revenue).[366]

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[365] Section 965 created a deemed income inclusion of accumulated non-previously taxed earnings. These earnings were taxed in tax year 2017 at reduced rates of eight percent for non-cash assets and 15.5 percent for cash assets. The rate reduction was achieved by a deduction applied to the income. Because of accounting year differences, some taxpayers reported their section 965 tax liability on their 2017 tax return, while other filers reported their section 965 tax liability on their 2018 tax return. The 2017 version of Form 1120 was not modified to reflect section 965. Taxpayers were instructed to attach a PDF (or portable document format) file to their return to reflect their inclusion amount and liability. As a result, section 965 income may and does appear in many locations on the 2017 version of Form 1120. For tax year 2018, Form 1120 includes on Schedule C the section 965(a) inclusion amount income as part of dividends (on line 15, column (a)) and the related section 965(c) deduction amount (on line 15, column (c)).

[366] This special weighting is necessary because the largest manufacturing corporations are substantially larger than the largest pharmaceutical corporations. The Joint Committee staff present a set of weighted averages in order to provide a comparable group of large non-pharmaceutical manufacturing corporations (labeled below as "large manufacturing"). This was done by dividing the sample into 25 groups based on their assets and return on assets reported on Form 1120 for tax year 2016. Lastly, the Joint Committee staff apply weights such that the distribution of large non-pharmaceutical manufacturing corporations mirrors the distribution of large pharmaceutical corporations.

In Figure 1, gross profit is gross receipts less cost of goods sold (*i.e.,* U.S. sales by the U.S. taxpayer less cost of goods, as reported on Form 1125). For pharmaceutical corporations, gross profits comprised approximately 30 percent of gross income from 2014 to 2020. Figure 2 shows the average amount of GILTI included in billions from 2018 to 2020. Pharmaceutical companies had much larger GILTI inclusions on average than either all corporations or large manufacturing, averaging over $4 billion a year in 2019 and 2020.

Figure 1.—Gross Profit as a Percentage of Gross Income by Year

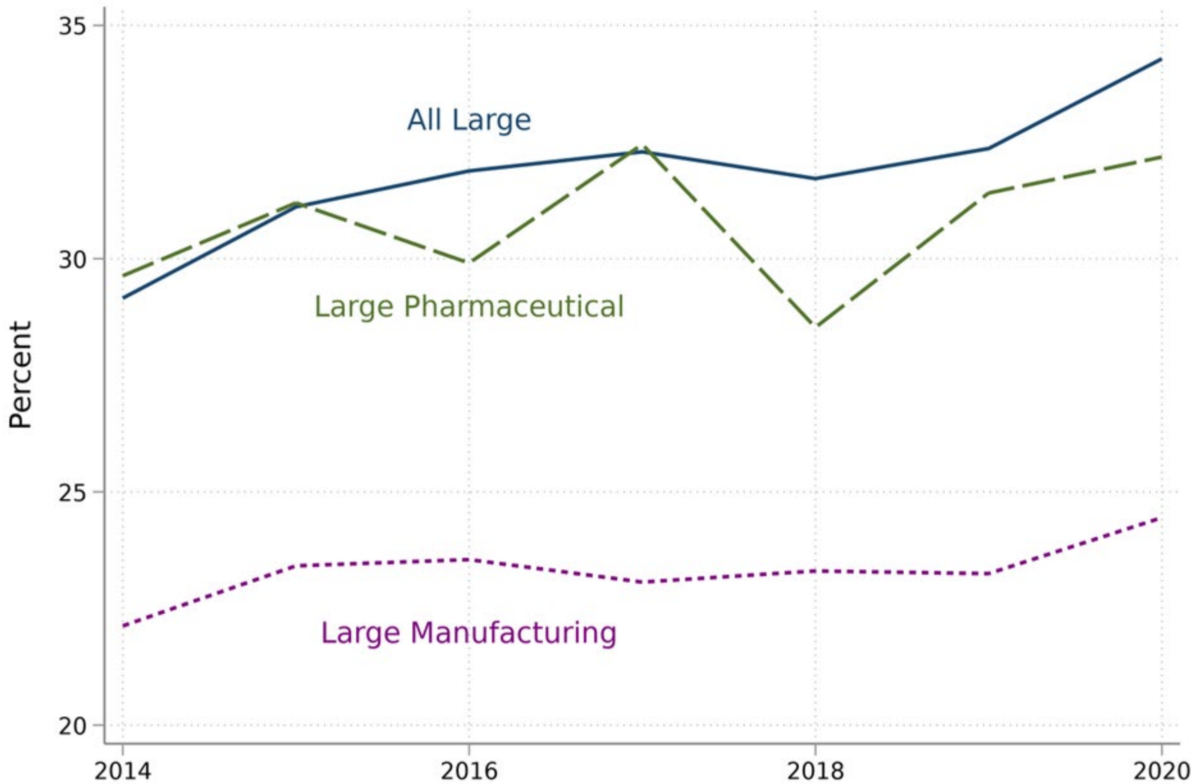


Figure 2.—Average Amount of GILTI by Year in Billions of Dollars

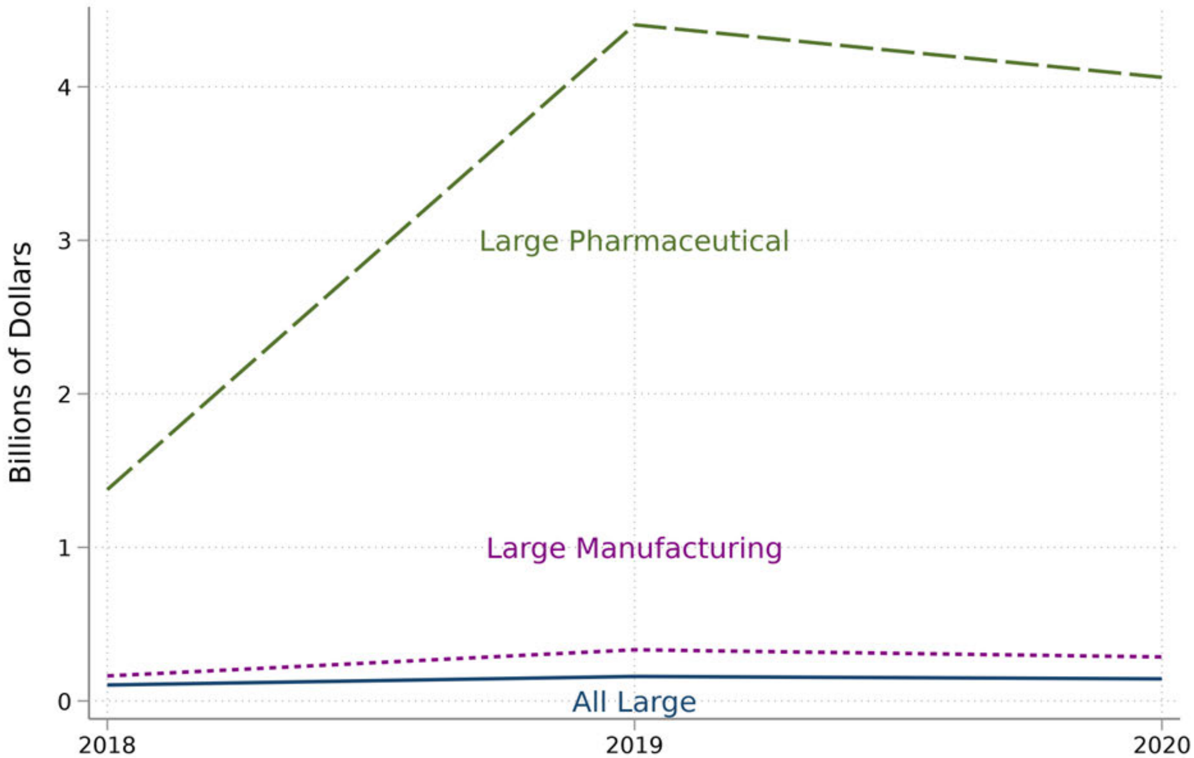
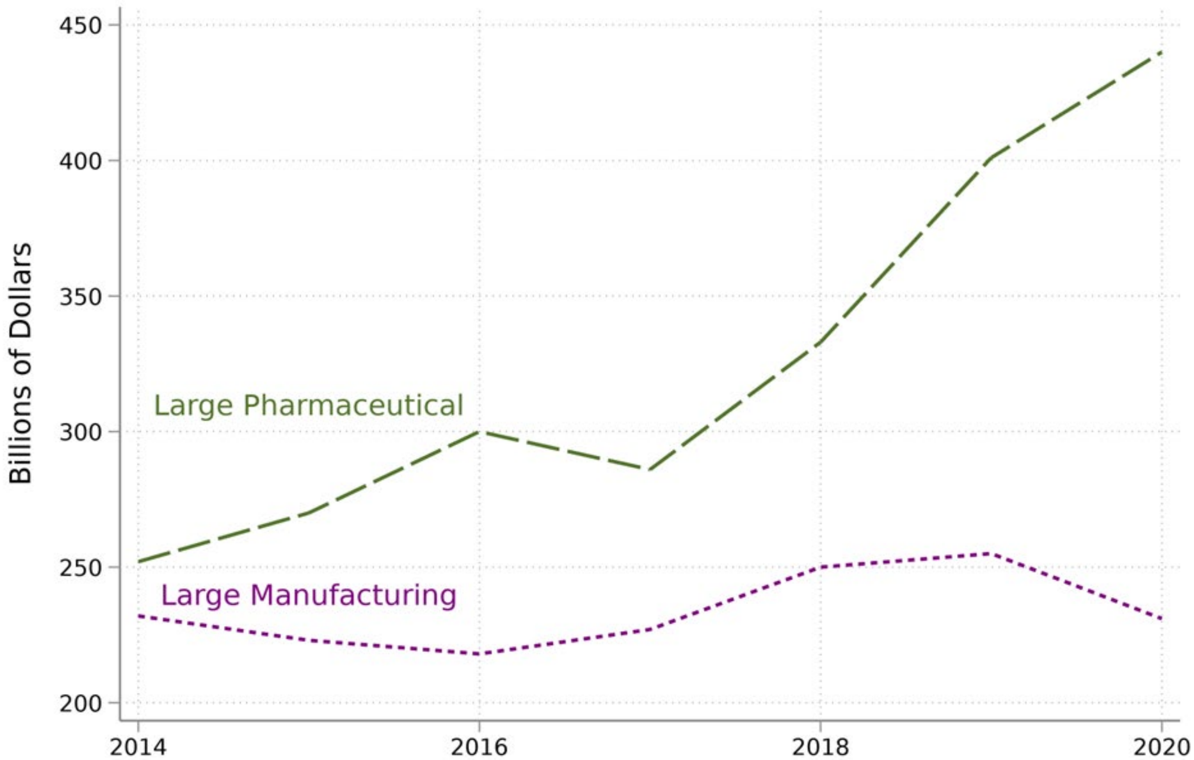


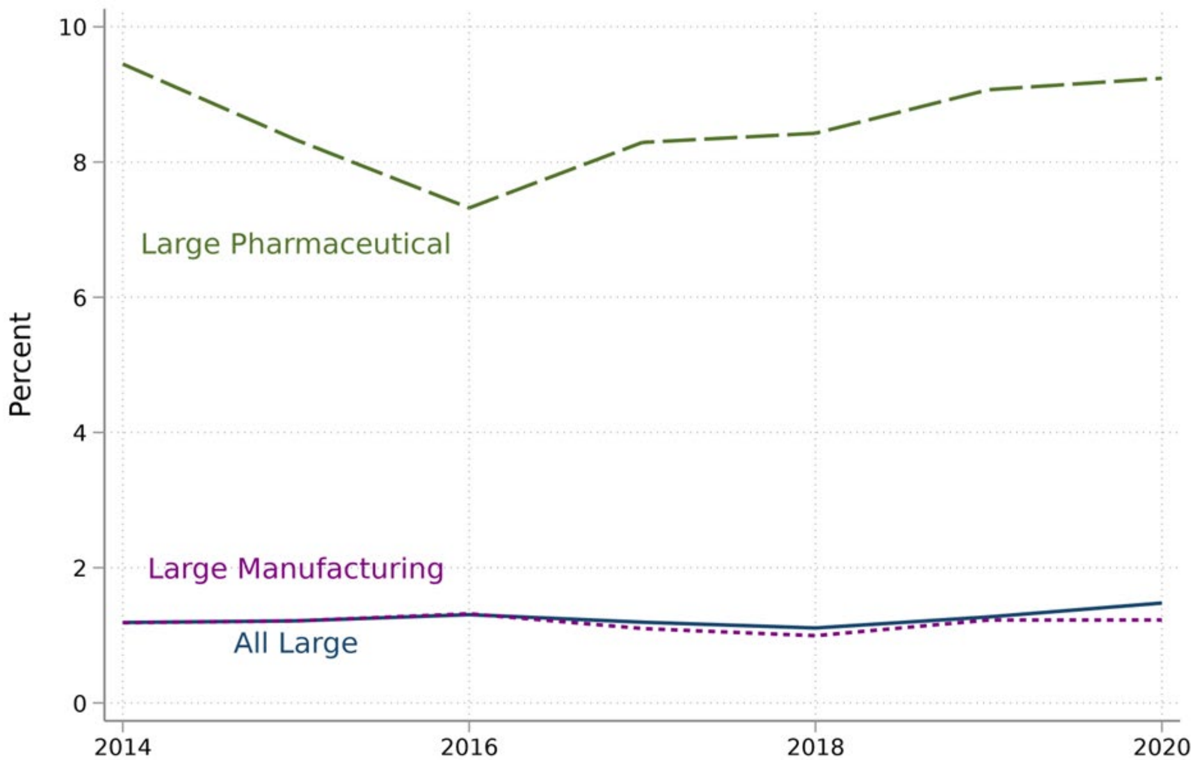
Figure 3 shows the level of gross income including GILTI by year in billions of dollars for large pharmaceutical and large manufacturing. The increase in GILTI income for pharmaceutical companies shows up as a large swing in gross income in the years after 2017, highlighting the necessity to use a measure of gross income excluding GILTI.

Figure 3.—Gross Income Including GILTI by Year for Large Manufacturing and Pharmaceutical Corporations in Billions of Dollars



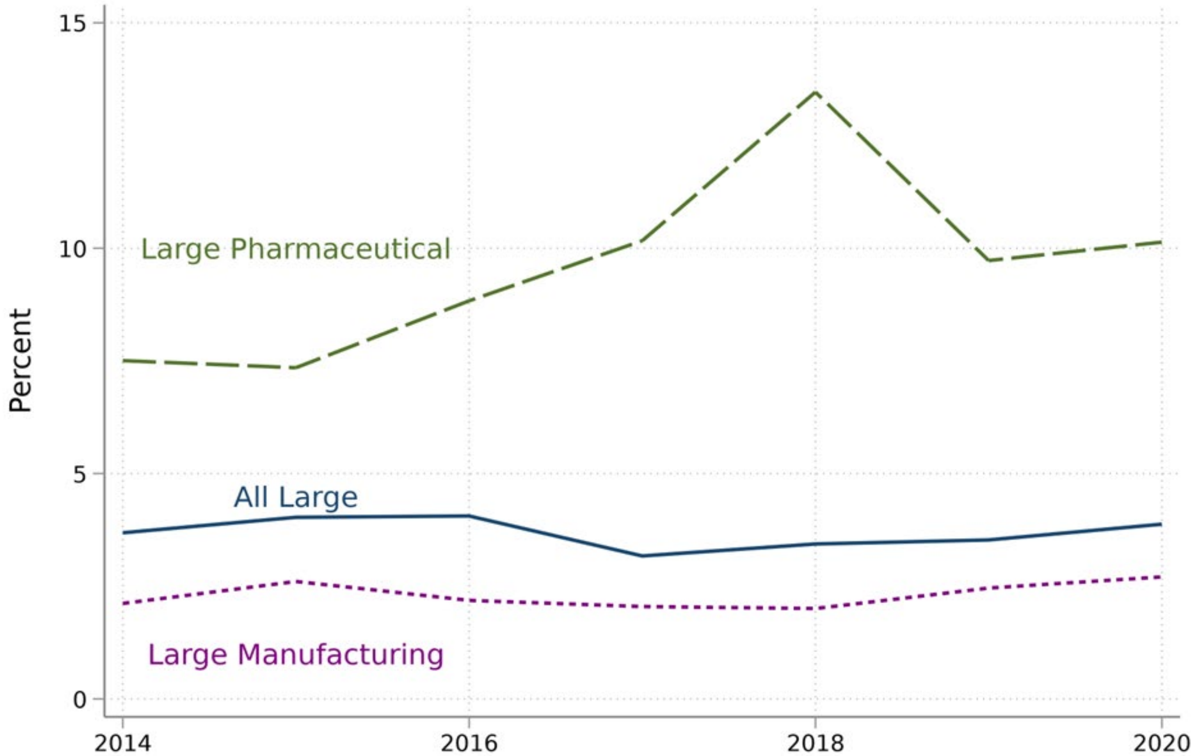
Royalties and other income (as reported on line 10 of Form 1120)[367] are also important for large pharmaceutical corporations. As seen in Figures 4 and 5, large pharmaceutical corporations generally have about eight percent of their gross income attributable to royalties, and between eight and ten percent of their gross income attributable to other income. Regarding royalties, this percentage is between five and eight times greater than the percentages reported by the other large corporations. Regarding other income, this percentage is between two and six times greater than the percentages reported by the other large corporations.

Figure 4.—Royalties as a Percentage of Gross Income by Year



[367] Other income is income that is not reported on lines 1 through 9 of Form 1120. Lines 1 through 9 include gross receipts less cost of goods, dividends, interest, rents, royalties, and capital gains and losses. Per instructions for line 10 Form 1120, other income includes recoveries of bad debts, Form 6478 biofuel producer credit, Form 8864 biodiesel and aviation fuels credits, refunds of taxes deducted in prior years, partnership income, transferred loss amount under section 91, certain last in first out recapture amounts, certain portions of section 481(a), income from cancellation of debt, and income from passive foreign investment companies.

Figure 5.—Other Income as a Percentage of Gross Income by Year



The next set of figures, Figures 6 to 9, show specific expense and deduction items claimed by the relevant taxpayers as a percentage of gross income. Figure 6 shows cost of goods sold, as reported on line 2 on Form 1120, as a percentage of gross income. Cost of goods sold as a percentage of gross income is substantially higher for large manufacturing corporations than large pharmaceutical corporations.

Figure 6.—Cost of Goods Sold as a Percentage of Gross Income by Year

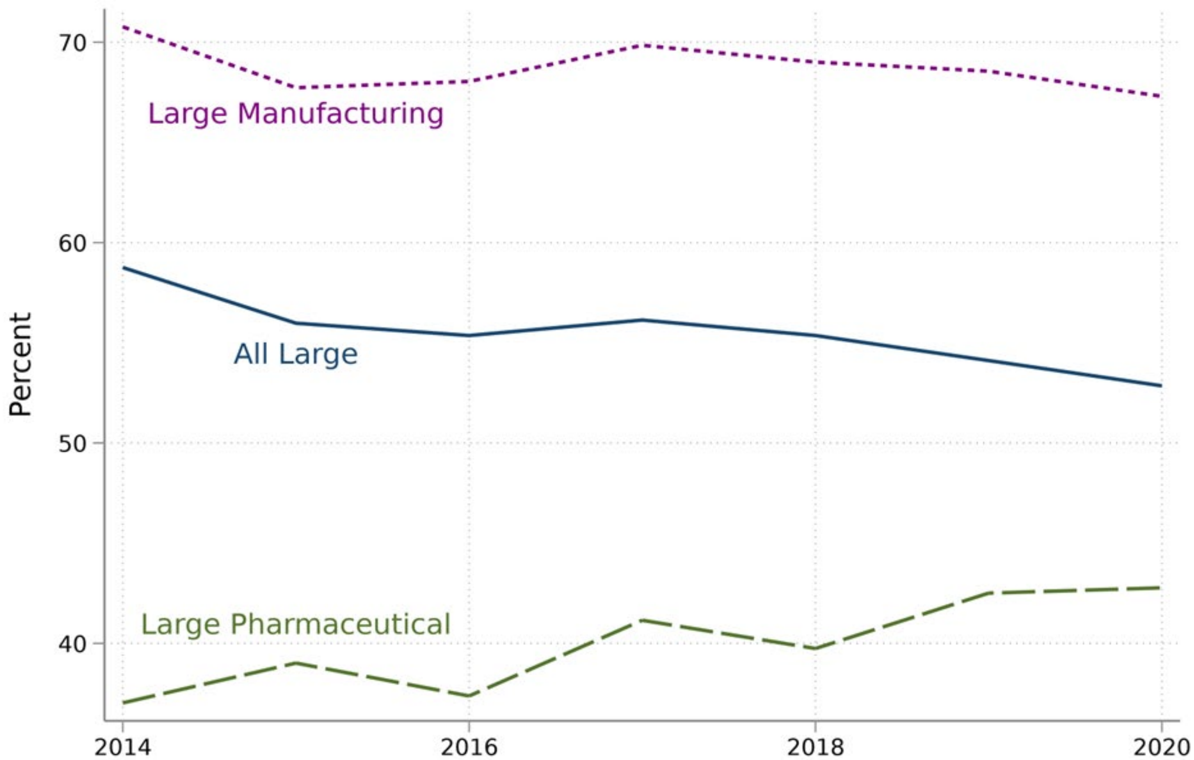
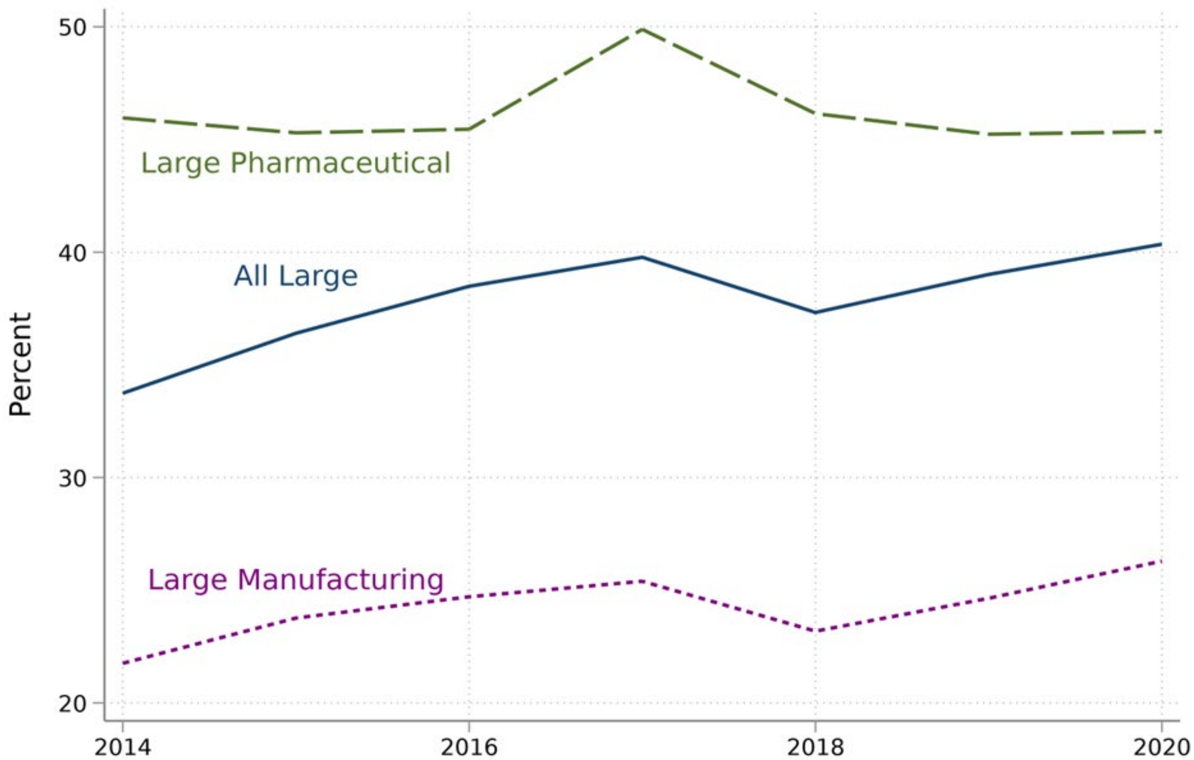


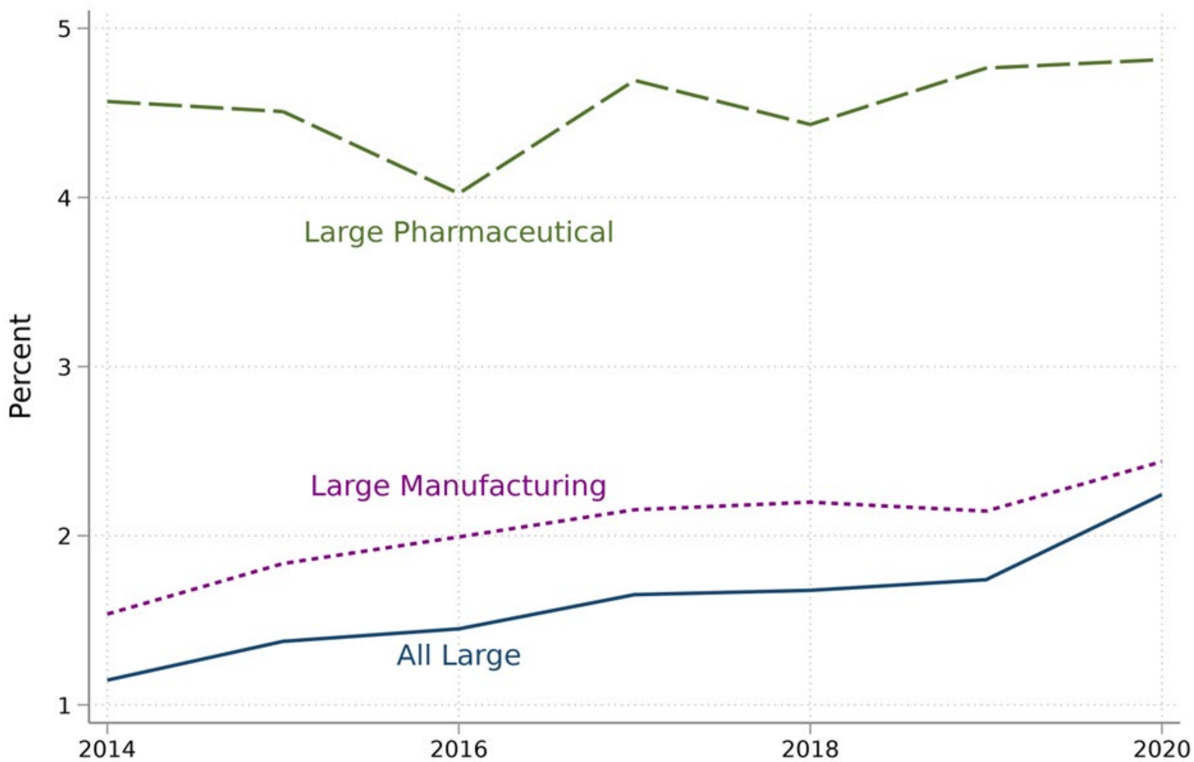
Figure 7 reports total deductions as a percentage of gross income. Total deductions are the sum of deductions claimed on lines 12 through 26 of Form 1120 and do not include special deductions (*e.g.,* section 250). Combined with the results from Figure 3 (Gross Income in levels including GILTI), which showed large pharmaceuticals had more gross income than large manufacturing, large pharmaceutical companies have not only more deductions as a share but also substantially more deductions on average than large manufacturing corporations.

Figure 7.—Total Deductions as a Percentage of Gross Income by Year



Consistent with higher royalties as reported in Figure 4, Figure 8 reports R&D expenditures, as reported on Form 6765,[368] are substantially higher for large pharmaceutical corporations than large manufacturing corporations and all other large corporations.

Figure 8.—R&D Expenditure as a Percentage of Gross Income by Year



[368] Form 6765, *Credit for Increasing Research Activities.* The amounts reported here may be a lower bound, as not all research expenditures are eligible for the section 41 research credit.

C. Foreign Income and Taxes

Large corporations may use branches or disregarded entities ("DREs") in various tax planning structures that, for example, may avoid the treatment of certain related party income as subpart F income. Taxpayers can elect, on Form 8832, to treat certain entities as DREs for U.S. tax purposes. Figure 9 shows that large pharmaceutical corporations have a substantially higher average number of DREs than large manufacturing corporations and all large corporations. Moreover, after the passage of Public Law 115-97, the number of DREs increases sharply from 2017 to 2019. In contrast, the average number of Forms 5471 ("Information Return of U.S. Persons With Respect to Certain Foreign Corporations") was flat over the period for large pharmaceuticals at approximately 80 per corporation. This indicates that large pharmaceuticals are seemingly increasing their usage of DREs, not simply converting existing CFCs that are not disregarded.

Figure 9.—Average Number of DREs by Year

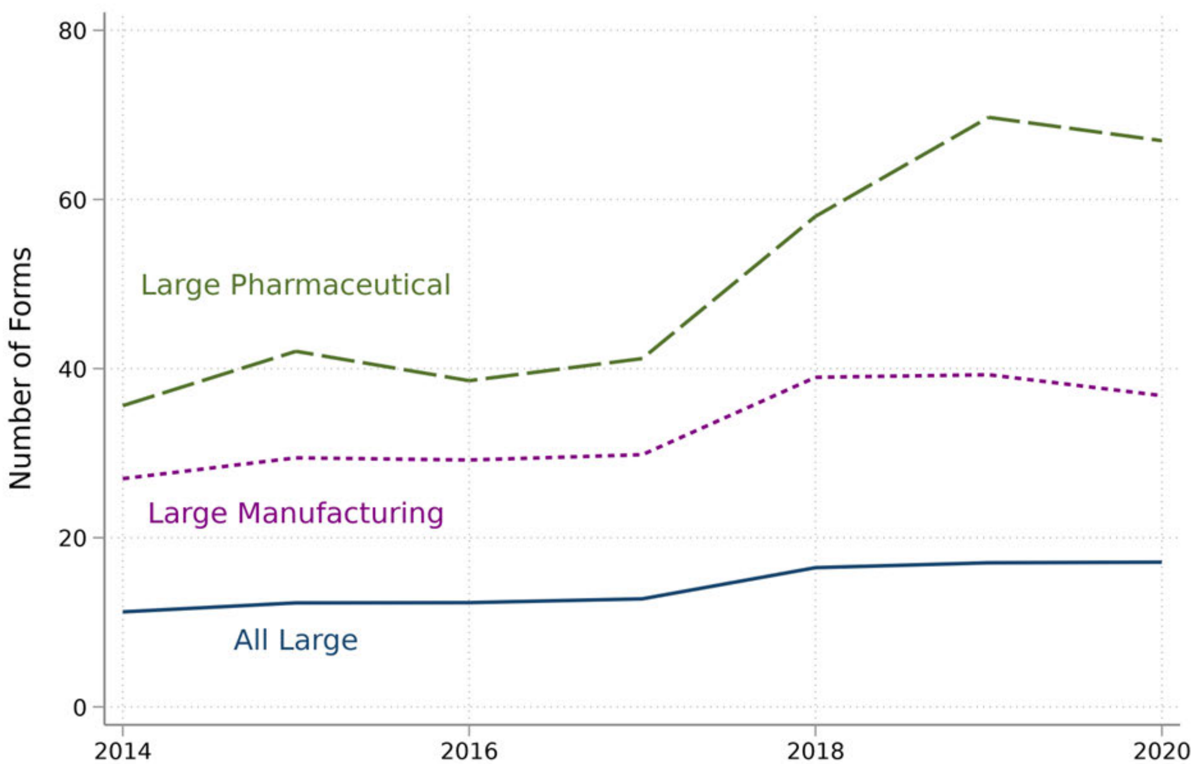
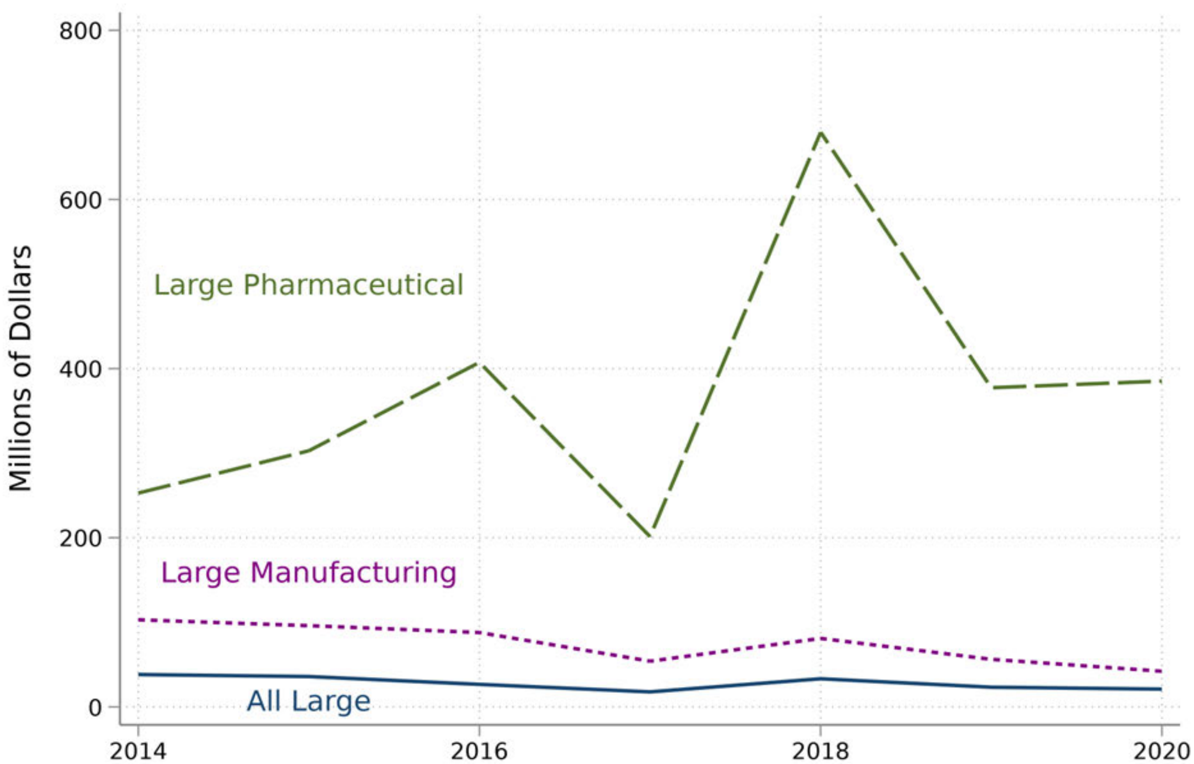


Figure 10 shows the average value of foreign tax credits claimed by corporation and year. Large pharmaceutical corporations have foreign tax credits on average between $200 million in 2017 and $680 million in 2018.[369] The prominent decline in 2017 may be due to fiscal year filers delaying repatriations in 2017 until they were eligible in 2018 for more favorable treatment.[370] In contrast, large manufacturing corporations have foreign tax credits on average between $40 million and $86 million. Also, large manufacturing corporations exhibit a relatively low year in 2017 of $49 million and a relatively high year in 2018 of $74 million.

Figure 10.—Average Value of Foreign Tax Credits Claimed by Year in Millions of Dollars



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[369] The $680 million outlier in 2018 includes foreign tax credit amounts attributable to the section 965 repatriation.

[370] Tim Dowd, Chris Giosa, and Thomas Willingham, "Corporate Behavioral Responses to the TCJA for Tax Years 2017-2018," *National Tax Journal*, vol. 73, no. 4, December 2018, pp. 1109-1134.

D. Domestic and Foreign Activity as Reported on Country-by-Country Form 8975

In 2016, the IRS began collecting data that conforms to the OECD country-by-country reporting standards by using Form 8975.[371] On this form, large corporations reported their profits, revenues, assets, and tax on a jurisdiction-by-jurisdiction basis. Filing was voluntary in the first year of the program and mandatory thereafter. Here, the Joint Committee staff report information on the set of corporations that filed Form 8975 in 2018, 2019, and 2020. For the purposes of the following figures (Figures 11 to 14), the Joint Committee staff limits the sample to corporations that appear in each year from 2018 to 2020. Each figure contains averages for all corporations required to file Form 8975 and separately for pharmaceutical and manufacturing corporations.[372]

In addition, the Joint Committee staff present a set of weighted averages in order to provide a comparable group of large non-pharmaceutical manufacturing corporations (labeled below as "large manufacturing"). This was done by dividing the sample into 25 groups based on their tangible assets and return on tangible assets reported on Form 8975 for the 2018 to 2020 period. Lastly, the Joint Committee staff apply weights such that the distribution of large non-pharmaceutical manufacturing corporations mirrors the distribution of large pharmaceutical corporations.[373]

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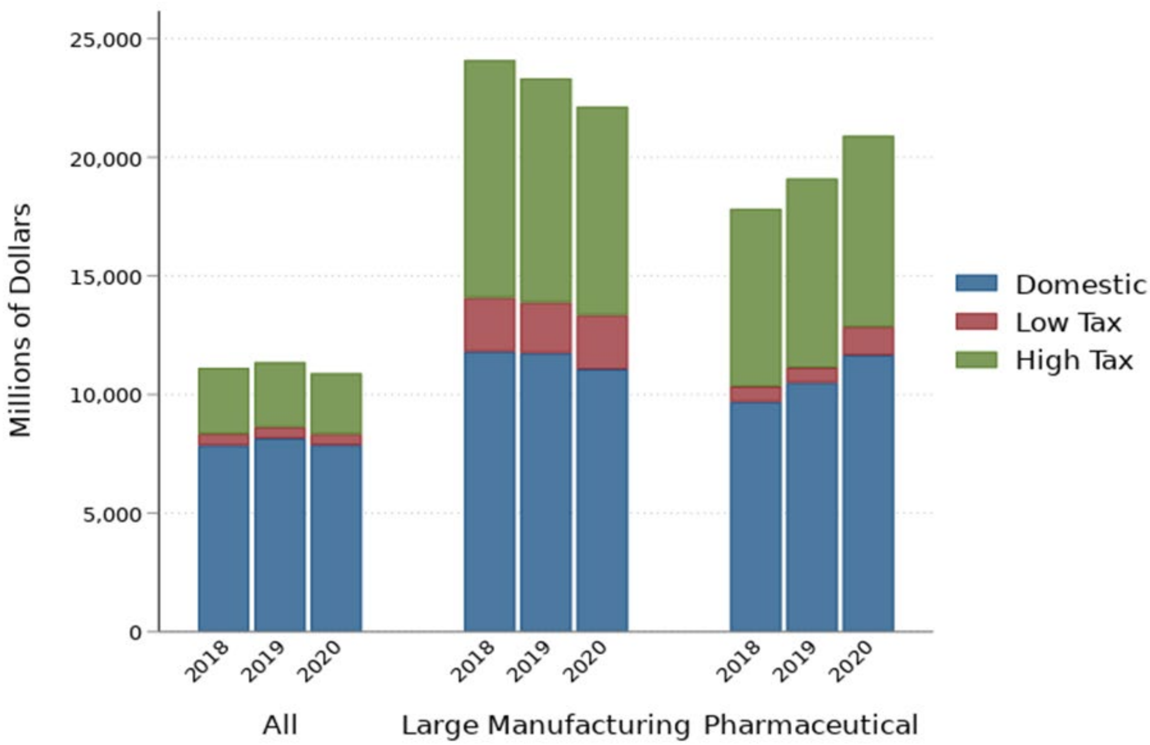
[371] Form 8975 is required by Treasury Regulation section 1.6038-4 and includes both corporations and partnerships as the ultimate owner. Corporations are approximately 90 percent of the ultimate owners and report approximately 95 percent of the revenues. There are several important ambiguities to note when interpreting this data. MNEs can and do use a variety of financial reporting standards and can choose whichever one they would like to use for reporting information on Form 8975 (*e.g.,* an MNE may use different financial reporting standards with respect to different operations in different countries). Consequently, what is included in the income and tax items will differ across MNEs. Additionally, despite a change from the original instructions for Form 8975, some taxpayers appear to be reporting profits and related party revenues on an aggregate rather than a consolidated basis, leading to potential double counting in certain data items. This is likely less of an issue for unrelated revenues, tangible assets, taxes, and employees. Finally, taxpayers were instructed to report as stateless all income, assets, and employees for entities that are passthroughs or transparent for tax purposes in a given jurisdiction. As a result, the Joint Committee staff dropped the stateless category from our calculations to further reduce instances of double counting of income.

[372] Construction of the sample in this subsection is based on Form 8975 and is not identical to the sample used in the prior subsection, though there may be substantial overlap.

[373] Because of the reliance on profit/loss reporting, this weighting procedure is affected by the double counting issues discussed earlier.

Figure 11 displays the average amount of unrelated revenues by corporation and jurisdiction. Here, the average amount of unrelated revenues is defined as the average amount of revenues from unrelated persons. The Joint Committee staff have categorized jurisdictions by "low tax" and "high tax" based on the median GAAP ATR within the jurisdiction in 2020. [374] Figure 11 shows that the average pharmaceutical corporation subject to country-by-country reporting requirements exhibit larger unrelated revenues and a larger foreign share of those revenues than the average reporting corporation. The weighted "large manufacturing" corporations have larger unrelated revenues.

Figure 11.—Average Unrelated Revenues by Corporation and Jurisdiction



[374] The GAAP ATR was calculated as tax accrued divided by profit for entities reporting positive profit. Jurisdictions with median GAAP ATRs below 12.5 percent were classified as low tax, and jurisdictions above 12.5 percent were classified as high tax. This measure of tax rates is susceptible to the double counting issues stemming from aggregate reporting, but the use of the median rates here reduces the impact of outlier entities. Inspection shows that these median rates are largely similar to statutory rates for many jurisdictions.

Figures 12 and 13 report employee counts and amount of tangible assets by corporation and jurisdiction. On average, large pharmaceutical corporations report a higher share of employees and tangible assets in low-tax jurisdictions than the overall sample as well as the weighted sample of manufacturing corporations. Their overall foreign share of both employees and assets are higher than the overall sample but roughly similar to the weighted manufacturing sample.

Figure 12.—Average Employees by Corporation and Jurisdiction

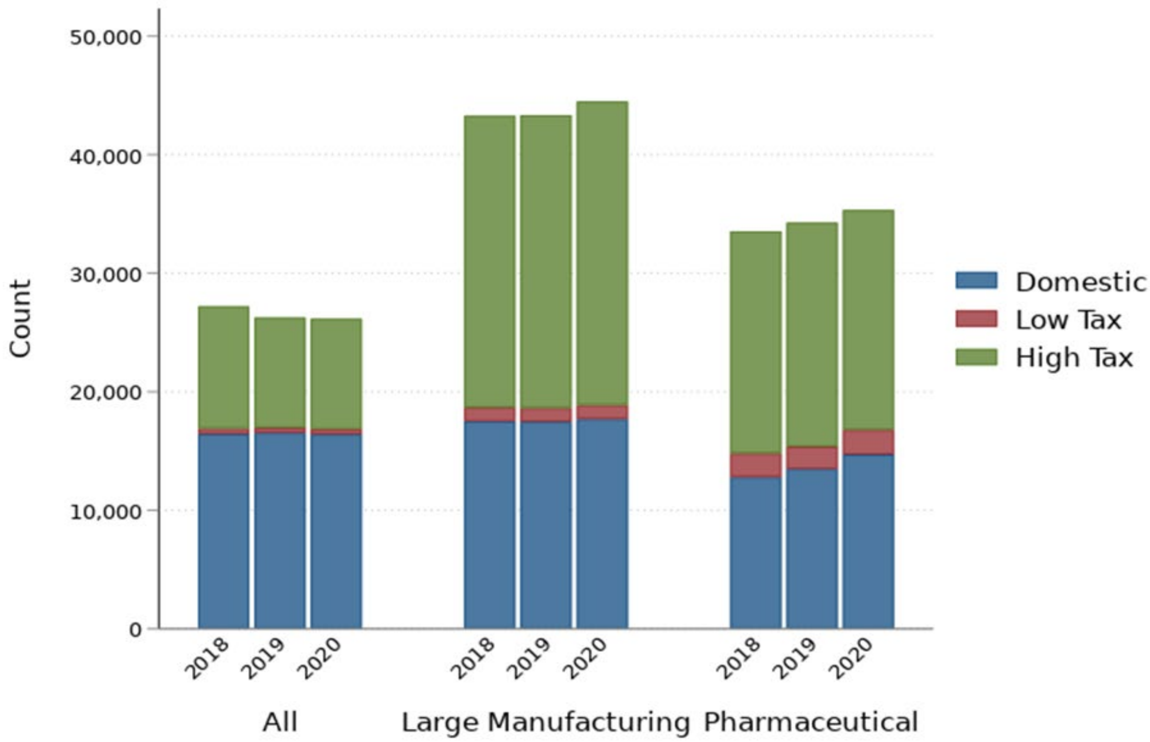
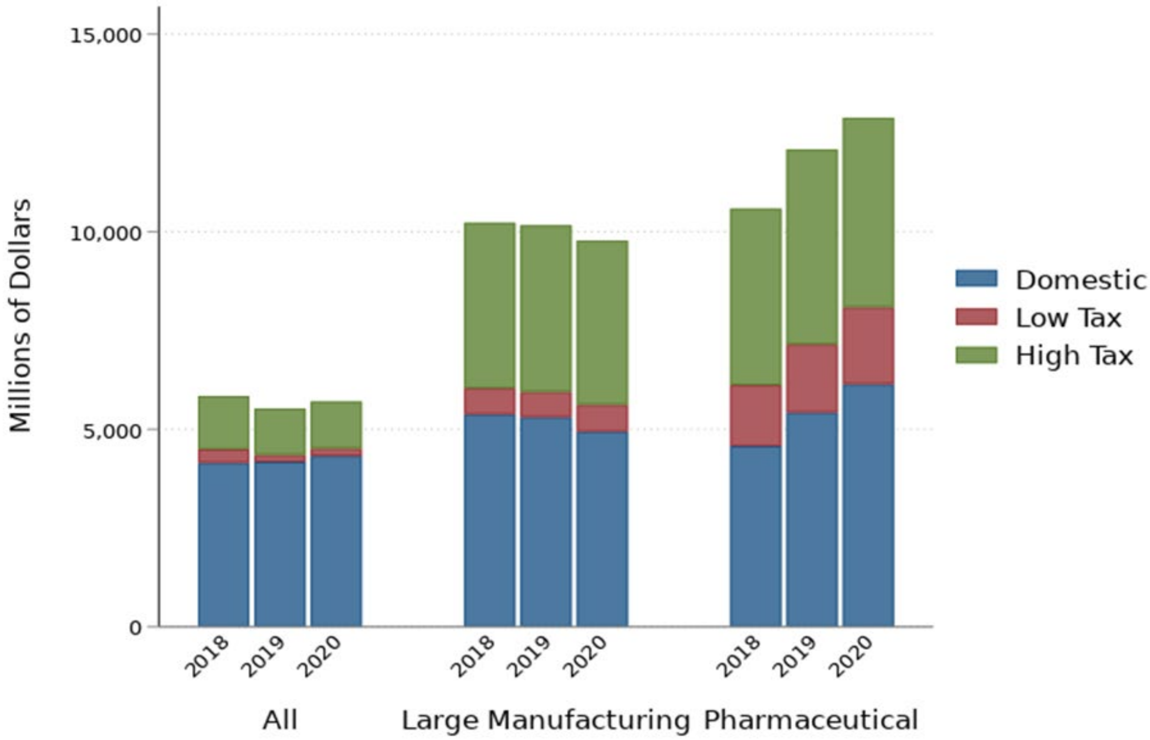
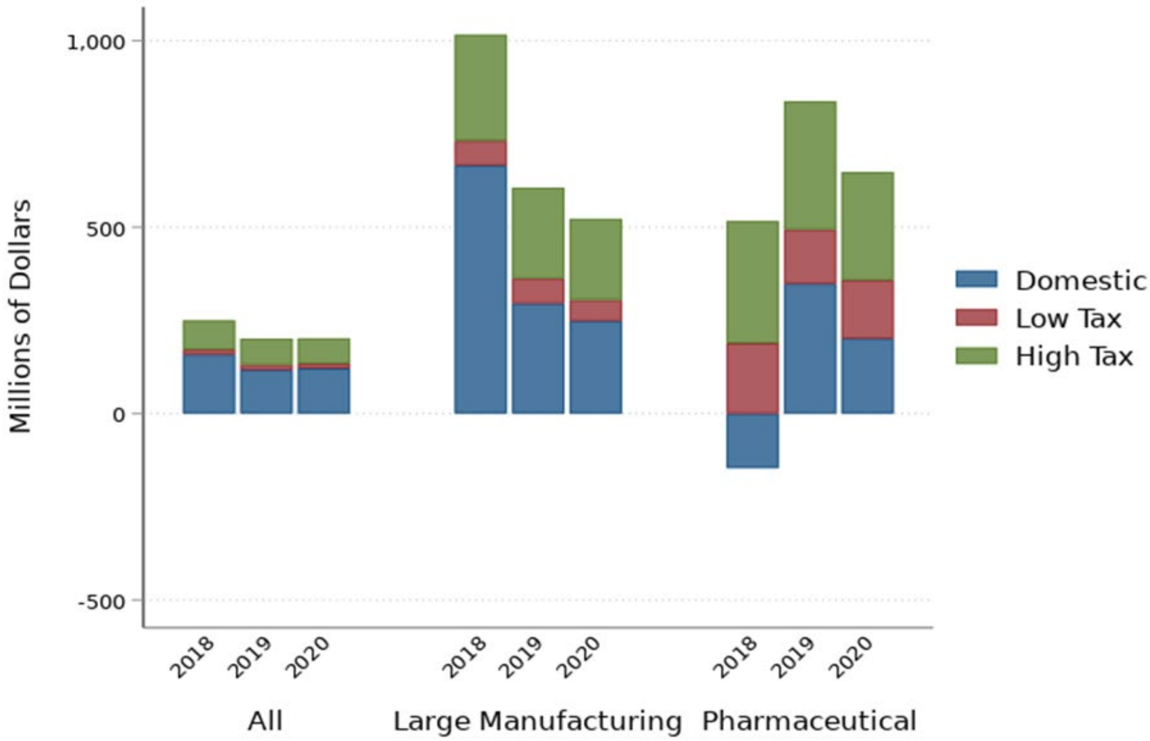


Figure 13.—Average Tangible Assets by Corporation and Jurisdiction



Lastly, Figure 14 presents statistics on taxes accrued by corporation and jurisdiction. First, the reporting in 2018 was affected by the treatment of section 965 tax liability. Aside from that anomaly, the results for taxes accrued show similar shares of foreign taxes relative to total taxes for both large manufacturing and pharmaceutical corporations. In the case of large pharmaceutical corporations, more of those accrued to low tax jurisdiction.

Figure 14.—Average Taxes Accrued by Corporation and Jurisdiction



APPENDIX A: SELECTION OF DIGITAL SERVICE TAXES

Digital services taxes ("DSTs") refer to unilateral attempts by countries to impose taxes on the revenue generated by the digital activity of (largely) foreign multinational companies operating within their jurisdiction. Often, companies who generate digital revenue across many jurisdictions do not maintain a physical presence in the countries in which they operate. DSTs are a mechanism for taxing the activity of companies who might otherwise fall out of the country's income tax base. DSTs can target a range of digital activities, including advertising, streaming, the operation of intermediary services (such as online marketplaces), and the collection and sale of user data. For example, the United Kingdom's DST imposes a two percent tax on the revenue from online marketplaces, search engines, and social media platforms which derive value from United Kingdom users. Austria's DST imposes a five percent tax on revenues from digital advertisement services. Certain countries, like Colombia and Belgium, have proposed or enacted laws that deem a foreign company to have a significant economic presence ("SEP") if they provide digital services to domestic users. Companies with SEP status are subject either to the country's income tax or to a tax on their revenues. The table below gives an overview of some the various DSTs proposed or enacted by countries.

Country	**Status**	**Effective Date**	**Type**	**Rate**
Argentina	Enacted	December 15, 2020	WHT	8 percent
Austria*	Enacted	January 1, 2020	DST	5 percent
Belgium	Waiting for Global Solution	Expected 2023 if global consensus is not reached	DST/Digital PE	3 percent
Brazil	Proposed	TBD	DST	1 percent – 5 percent (depending on revenue)
Canada	Proposed	January 1, 2024 (on revenues earned as of January 1, 2022)	DST	3 percent
Colombia	Enacted	January 1, 2024	SEP or alternatively WHT	10 percent WHT or 3 percent income tax
Republic of Congo	Enacted	January 1, 2021	WHT	10 percent
Costa Rica	Enacted	November 19, 2019	General income tax on digital tourist rental services income	NA

Country	Status	Effective Date	Type	Rate
Czech Republic	Proposed (rejected)	TBD	DST	7 percent but may be reduced to 5 percent
Denmark	Proposed	TBD	DST	6 Percent
France*	Enacted	1/1/2019	DST	3 percent
Hungary	Enacted	July 1, 2017 (Implementation delayed until December 31, 2023)	DAT	7.5 percent
India*	Enacted	April 1, 2022	SEP	N/A
	Enacted	April 1, 2020	DST	2 percent
	Enacted	June 1, 2016	DAT	6 percent
Indonesia	Waiting for Global Solution	March 31, 2020	Digital PE	NA
	Waiting for Global Solution	March 31, 2020	DST	N/A
Israel	Enacted	April 11, 2016	Digital PE	NA
Italy*	Enacted	January 1, 2020	DST	3 percent
Kenya	Enacted	January 1, 2021	DST	1.5 Percent
Malaysia	Enacted	May 13, 2019	WHT	Variable
Mexico	Enacted	June 1, 2020	WHT	Variable
Nepal	Proposed	July 17, 2022	DST	2 percent
Nigeria	Enacted	February 3, 2020	SEP	6 percent
Pakistan	Enacted	July 1, 2018	WHT	10 percent
Paraguay	Enacted	January 1, 2021	WHT	4.5 percent
Peru	Enacted	January 1, 2007	WHT	30 percent
Poland	Enacted	July 1, 2020	DST	1.5 percent
	Proposed	TBD	DAT	5 Percent
	Proposed	TBD	DST	7 Percent

Country	Status	Effective Date	Type	Rate
Portugal	Enacted	February 17, 2021	Exhibition levy	4 percent
	Enacted	February 17, 2021	Annual levy	1 percent
Sierra Leone	Enacted	January 1, 2021	DST	1.5 percent
Slovakia	Enacted	January 1, 2018	Digital PE	N/A
Spain*	Enacted	January 16, 2021	DST	3 percent
Taiwan	Enacted	January 1, 2017	WHT	To be agreed with the tax authority
Tanzania	Enacted	July 1, 2022	DST	2 percent
Tunisia	Enacted	January 1, 2020	DST	3 percent
Turkey*	Enacted	January 1, 2019	WHT	15 percent
	Enacted	March 1, 2020	DST	7.5 percent but the President can reduce to 1 percent or increase to 15 percent
United Kingdom*	Enacted	April 1, 2020	DST	2 percent
Uruguay	Enacted	January 1, 2018	Non-resident income tax	12 percent
Vietnam	Enacted	January 1, 2021	WHT	Variable
Zimbabwe	Enacted	January 1, 2019	General income tax on certain digital services income	5 percent

* Entered into agreement with the United States whereby the United States terminates tariffs imposed under Section 301 of the Trade Act of 1974 in exchange for country making any DST liabilities collected before the implementation of Pillar One creditable against future Pillar One taxes.
DAT: Digital Advertising Tax
DST: Digital Service Tax
PE: Permanent Establishment
SEP: Significant Economic Presence
WHT: Withholding Tax
Source: Joint Committee compilation from text of local country statutes.

APPENDIX B: SELECTION OF COUNTRIES ADOPTING PILLAR TWO

Country	Legislation	Status	IIR	UTPR	QDMTT
Canada	2023 Budget stated government's plan to introduce draft legislation implementing IIR and QDMTT, with UTPR to follow at later time, March 28, 2023.	Plan to Introduce legislation	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Yes (From December 31, 2023)
Japan	Japanese Parliament passed legislation which included the implementation of certain Pillar Two global minimum tax rules, March 28, 2023.	Enacted Law	Yes (From April 1, 2024)	No	No
Liechtenstein	Government published draft legislation and open consultation on measures to implement a global minimum tax, March 29, 2023.	Draft Legislation Published	Yes (From January 1, 2024)	Yes (From January 1, 2025)	Yes (From January 1, 2024)
South Korea	Korea enacted new global minimum tax rules to align with the OECD's Pillar Two Model Rules, December 31, 2022.	Enacted Law	Yes (From January 1, 2024)	Yes (From January 1, 2024)	No
Switzerland	The Swiss Federal Council opened consultation on a temporary ordinary entitled for the implementation of Pillar Two, August 17, 2022.	Draft Legislation Published	Yes (From January 1, 2024)	Yes (From January 1, 2024)	Yes (From January 1, 2024)
United Kingdom	Building on draft legislation published in July 2022, Finance (No. 2) Bill was introduced in the House of Commons and included measures to implement a 'Multinational Top-Up Tax', March 23, 2023.	Legislation Introduced to Parliament	Yes (From December 31, 2023)	No (Intention to implement at later time)	Yes (From December 31, 2023)
EU	Unanimous agreement on EU Global Minimum Tax Directive for the implementation of Pillar Two global minimum tax rules among member states, December 14, 2022.	EU Directive	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Optional for Member States

EU Member Countries

Germany	The German Federal Ministry of Finance published a consultation including a draft law to implement the EU Global Minimum Tax Directive, March 20, 2023.	Draft Legislation Published	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Yes (From December 31, 2023)
Ireland	Ireland's Department of Finance published a Feedback Statement including possible draft legislation to implement the EU Global Minimum Tax Directive, March 31, 2023.	Feedback Statement	Yes (From December 31, 2023)	Yes (From December 31, 2024)	No (Intention to implement at later time)
The Netherlands	Open consultation on draft legislation entitled "Minimum Tax Rate Act 2024", to implement Pillar Two, October 24, 2022.	Draft Legislation Published	Yes (From December 31, 2023)	Yes (From December 31, 2024)	Yes (From December 31, 2023)
Sweden	Swedish Special Investigator submitted an interim report which included draft legislation for the implementation of the EU Global Minimum Tax Directive, February 7, 2023.	Draft Legislation Published	Yes (After December 31, 2023)	Yes (After December 31, 2024)	Yes (After December 31, 2023)

Note: Other countries that have introduced or plan to introduce legislation adopting Pillar Two: Australia, Azerbaijan, Bulgaria, EU member countries (Austria, Belgium, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Romania, Slovakia, and Slovenia), Guernsey, Indonesia, Jersey, Malaysia, Mauritius, New Zealand, Norway, Qatar, Singapore, South Africa, Thailand, United Arab Emirates, and Vietnam.

Source: Joint Committee compilation from text of local country statutes and Council Directive (EU) 2022/2523 of 14 December 2022.