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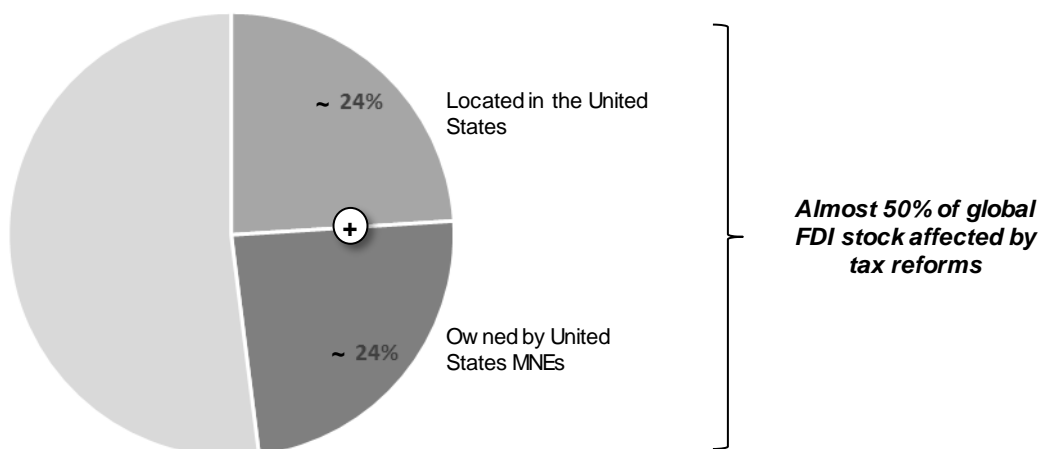
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TAX REFORMS IN THE UNITED STATES: IMPLICATIONS FOR INTERNATIONAL INVESTMENT

H I G H L I G H T S

- *The United States tax reform bill will have significant implications for global FDI patterns. It will affect MNEs and foreign affiliates accounting for almost 50% of global FDI stock.*
- *The bill could lead to the repatriation of almost \$2 trillion of overseas funds of United States MNEs, leading to sharp reductions in global FDI stocks.*
- *It could lead to structurally lower retained earnings in foreign affiliates and to a re-routing of FDI links in the international corporate structures of United States MNEs.*
- *The stimulus to investment in the United States provided by a lower tax rate and full investment expensing could lead to higher inward investment, and possibly to further re-shoring of manufacturing activity.*
- *Longer term, global investment patterns could also be affected by a greater degree of tax competition (offsetting the impact of the reforms on FDI).*

Figure 1. Global FDI positions affected by United States tax reforms



Source: UNCTAD.

Note: Global FDI stock in this illustrative figure is the average of global inward and outward stock.

Introduction

The United States Government adopted an important tax reform bill – the “tax cuts and jobs act” – in December 2017. Although many details are still being worked out and it will be some time before firms have assessed all the implications, the bill includes changes to the corporate tax regime that are likely to have important consequences for international investment. These changes will affect both cross-border investment into the United States and the investment positions of United States MNEs abroad. As such, they could have a significant impact on global investment patterns, given that almost half of global investment stock is either located in the United States or owned by United States multinationals (MNEs) (figure 1).

Key objectives of the reforms are to boost investment in the United States and to create jobs. To that end, the bill contains measures that directly affect the investment climate in the United States, and measures aimed at MNEs to encourage them to bring overseas funds back home and to reduce the incentive for them to locate certain assets and activities abroad. The package also contains measures to tackle tax avoidance through complex cross-border corporate structures.

Measures that will directly affect the investment climate in the United States include:

- (i) A reduction of the statutory corporate income tax (CIT) rate from 35% to 21% effective from 2018.
- (ii) Immediate full expensing of investment cost.
- (iii) The capping of deductible interest to 30% of taxable income.

Measures directed at the international tax regime for MNEs include:

- (iv) A switch to a territorial tax system through a 100% deductibility of dividends of foreign affiliates.
- (v) A transitional measure for existing overseas retained earnings in the form of a mandatory deemed repatriation subject to a one-off tax payment (15.5% on cash, 8% on illiquid assets).
- (vi) A set of anti-avoidance measures, including a tax on global intangible low-tax income and a tax on payments to overseas affiliated firms that erode the tax base in the United States.

Figure 2 provides an overview of the expected impact of these measures on global foreign direct investment (FDI) and on capital expenditures by MNEs in the United States. (It should be noted that the impact is likely to differ substantially by sector and industry; e.g. expected impacts for high-tech sectors are discussed in more detail below.)

Figure 2. Summary implications for international investment of US (corporate) tax reforms

		○ Low impact	● High impact
	Key measures	Potential impact on FDI	Potential impact on Capex
Investment climate	i. Corporate income tax reduction	○ Increases attractiveness of the US as an investment destination.	○ Could provide a stimulus to US domestic capex (stronger for domestic firms).
	ii. Investment expensing	○ Reduces investment costs, increasing the attractiveness of the US	● Likely to boost US domestic capex, including by MNEs.
	iii. Cap on interest deductibility	○ Reduces debt financing options and could decrease intra-firm loans. Could have a negative impact on highly leveraged cross-border M&A deals.	○ Could dampen capex effect where it leads to higher cost of capital. Negatively affects highly leveraged investments, in particular PE investments.
International tax structures	iv. Territorial tax system	○ Reduces the need for high levels of retained earnings overseas. Could lead to re-routing of US outward FDI stocks.	○ Limited impact, as the negative effect of the high tax rate was already off-set by tax-efficient corporate structures.
	v. Mandatory deemed repatriation	● Immediate impact on US outward FDI stocks; negative outflows as MNEs repatriate cash.	○ By itself, limited real impact from the repatriation of overseas cash – in combination with lower CIT and expensing it may boost capex by MNEs.
	vi. Anti-avoidance measures	● Could lead to re-routing of US outward FDI stocks. Differentiated impact by sector/industry; e.g. stronger impact on IP-intense sectors.	○ Limited real impact. May affect international corporate structures in IP-intense sectors (e.g. negative impact on overseas R&D) and financial sectors.

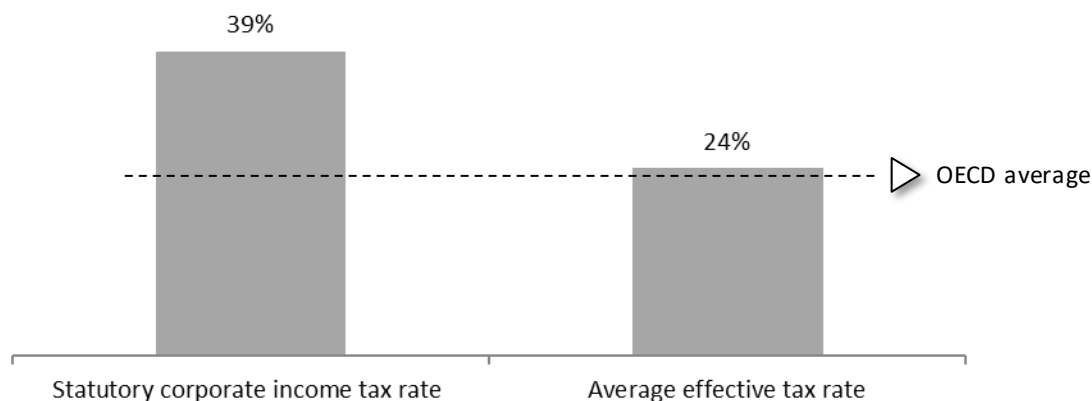
Source: UNCTAD.

Measures directly affecting the investment climate in the United States

The headline measure of the bill is the reduction in corporate income tax from 35% to 21%. This measure is undoubtedly beneficial for business in the United States, and it brings the nominal rate in line with the rate in most major developed economies – such as the 22% average rate in the EU, and the 24% average in OECD countries. However, the effect on international investment of this measure per se is likely to be limited. The many tax breaks in the complex fiscal environment in the United States already resulted in an average effective tax rate (AETR) close to the OECD average (figure 3). And MNEs (both United States MNEs and foreign investors in the United States) enjoyed an even lower rate than domestic businesses due to opportunities to avoid tax through their international networks.

The impact of the rate reduction on international investment is also likely to be limited because, while nominal income tax rates can be a factor in investment decisions (see *WIR15*), they are not among the most important investment determinants. Other locational factors, such as access to markets, technology, R&D facilities and labour costs are generally far more significant determinants. The reduction of the CIT rate by 14 percentage points is dwarfed by the labour cost differentials between the United States and, for example, the Asian economies that have been the manufacturing location of choice for many United States MNEs; hourly labour compensation costs in manufacturing in the United States are three times higher than the average of the five Asian economies that host most United States outward FDI stock in the sector.

Figure 3. Pre-reform nominal and effective corporate income tax rates in the United States



Source: United States Department of the Treasury's Office of Tax Policy.
 Note: Statutory rate includes Federal and State taxes.

A more impactful measure, in terms of stimulating investment, may be the full deduction of capital expenditures on equipment. This will provide a significant boost to firms in capital intensive sectors. A few large firms, including AT&T, Boeing and Apple, announced significant new investments in the United States shortly after the adoption of the bill. The effect is partly diluted by the cut in the CIT rate (full deductibility of expenditures would have been a greater boon under the 35% headline rate). Further dilution might occur through potential upward price pressures for capital equipment, but on balance past studies have shown a significant impact of comparable investment tax credits on capital expenditures in the United States.¹ However, while the measure will positively affect capital expenditures by both domestic firms and affiliates of foreign MNEs, the effect is likely to be most pronounced for expansions or upgrades of existing operations (with the possibility to reduce tax liabilities on existing income streams). The impact on new foreign investment flows into the United States is much less clear.

A dampening effect on investment might come from the cap on the deductibility of interest expenses to 30% of taxable income. In the current low-interest rate environment, and after the deleveraging that has taken place among corporations over the past decade, this cap will not pose a significant limitation for most businesses. (In fact, many

¹ The effect of the pre-1986 investment tax credits in the United States has been studied, e.g., in S.J. Carlson and C.T. Bathala (1994). "Impact Of The Repeal Of The Investment Tax Credit On Firms Investment Decisions", *Journal of Applied Business Research*, vol. 10 no. 2.

other countries are introducing caps following the recommendations of the OECD Base Erosion and Profit Shifting (BEPS) process.) However, it could increase the cost of capital for highly-leveraged businesses and for private equity investors, and it could affect M&A deals, including cross-border M&As, that rely on adding high levels of debt in acquisition targets.

The cap on interest deductibility can also be seen as an international tax measure, insofar as it affects intra-firm loans to affiliates in the United States of foreign MNEs, and payment of interest expenses to erode the tax base in the United States.

Measures affecting the international tax regime for MNEs

The most significant change to the tax regime for MNEs is the shift from a worldwide system (taxing worldwide income, with credits for taxes paid overseas) to a territorial system (taxing only income earned at home). This brings the United States regime closer to the majority of OECD economies. The shift is accomplished through a 100% deductibility of received foreign dividends.

The switch to a territorial system removes the anomaly of the regime whereby overseas earnings incurred tax liabilities that became payable only upon repatriation of funds to the United States, leading to vast amounts of deferred tax liabilities parked overseas. As a result, United States outward FDI stock is made up to a large extent of accumulated overseas profits, or retained earnings. As these retained earnings could be deployed for capital expenditures on a pre-tax basis, the possibility to defer tax liabilities indefinitely has effectively acted as a stimulus measure for the overseas operations of United States MNEs.² The possibilities provided by the United States international tax regime have allowed some of its MNEs to operate with significantly lower global average effective tax rates than their competitors from other regions. For example, General Electric has been found to have a global AETR of less than 10%, compared to more than 30% for its direct competitor Siemens (Germany).³ The AETRs reported by predominantly United States-based high-tech MNEs can be even lower.

As the incentive for United States MNEs to maintain large stocks of retained earnings overseas will be much reduced, the impact on FDI patterns could be significant. Of course, to some extent this effect is already caused by the lowering of the statutory rate to 21%, which removes much of the rate differential with (non-offshore) overseas locations of United States foreign affiliates, and with it the repatriation penalty under the old system.

The shift to territoriality and the huge existing stock of overseas deferred taxes necessitate a transitional measure included in the reform bill. All deferred taxes will be treated as if they were being repatriated, and taxed at relatively favourable rates (compared to the full statutory rates) of 15.5% for retained earnings held as cash, and 8% for non-cash assets, i.e. earnings that have actually been reinvested. This measure is widely expected to have the most significant and immediate effect on global investment patterns.

A tax break on repatriation has been long awaited by MNEs, since the last such break in 2005 in the form of the Homeland Investment Act (HIA). At the time, a one-time reduced rate was offered for repatriated funds, which led to about \$300 billion of retained earnings being brought back to the United States – causing significant negative outward FDI flows.

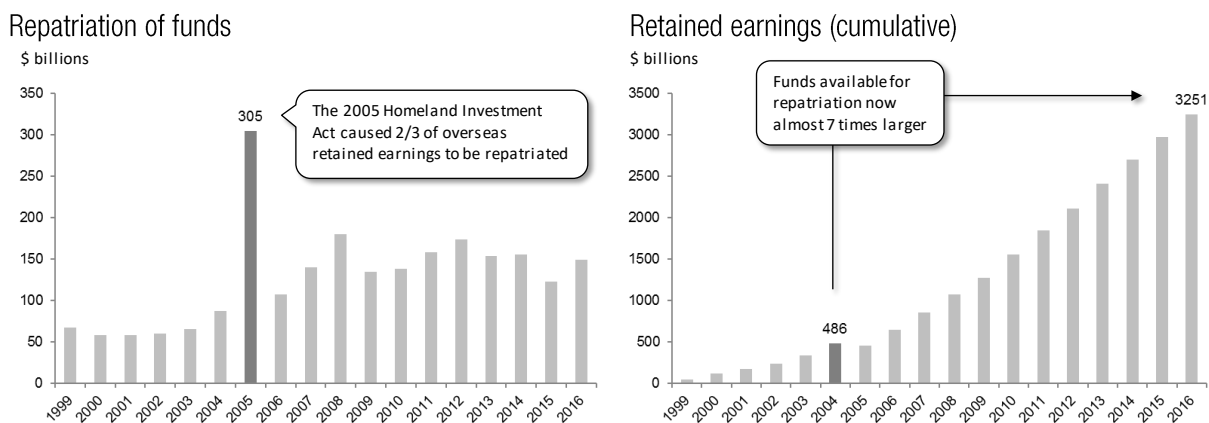
² Of course, the shift to a territorial system should in principle favour overseas operations of United States MNEs. A recent IMF working paper (Li Liu (January 2018), "Where Does Multinational Investment Go with Territorial Taxation? Evidence from the UK", IMF WP/18/7) finds that MNEs invested more overseas after the United Kingdom's shift to a territorial system in 2009.

³ See Allan Sloan and Jeff Gerth (2011). "The truth about GE's tax bill", *Fortune*, 4 April 2011. GE is now reportedly losing some of the tax advantage from its complex international structure, see "GE is a rare loser from US tax reform", *Financial Times*, 29 January 2018.

Overseas retained earnings of United States MNEs are now much higher. At \$3.2 trillion – with some \$2 trillion held in cash – they are now about seven times the level in 2005 (figure 4). Mandatory deemed repatriation could thus potentially lead to very large capital flows back to the United States, to the extent that it could affect the dollar exchange rate.⁴

However, a key contrast with the 2005 HIA is that, at the time, funds had to be repatriated in order to benefit from the reduced rate. As a result, an estimated two-thirds of the total funds available for repatriation were brought back (with the remainder presumably reinvested in non-liquid assets, or required for overseas operations). The current tax reform bill does not include such a requirement (or incentive) to actually repatriate funds. Therefore, MNEs may opt to keep a larger share of retained earnings overseas, either to finance future expansion and M&As, or because yields in emerging economies are higher.

Figure 4. Retained and repatriated earnings of United States MNEs



Source: UNCTAD analysis based on United States Bureau of Economic Analysis data.

Ultimately, the impact will depend on the actions of a relatively small number of very large MNEs that, together, hold the bulk of overseas cash. Five high-tech companies alone (Apple, Microsoft, Cisco, Alphabet and Oracle) together hold more than \$530 billion in cash overseas, i.e. one quarter of the total amount of liquid assets that are estimated to be available for repatriation. The 50 top overseas cash holders in the S&P 500 have parked about \$925 billion of cash outside the United States.⁵ The largest cash holders are IP-intensive MNEs in high-tech, pharmaceuticals, engineering and few branded consumer goods companies.

The potential impact on global FDI positions is clear. Mass repatriations could cause significant negative outward FDI flows and a large drop in the outward FDI stock position of the United States, from the current \$6.4 trillion to possibly as low as \$4.5 trillion, with inverse consequences for inward FDI stocks in other countries. About one quarter of United States outward stock of FDI is located in developing countries. However, it is likely that a relatively large share of the stock located in developing countries is invested in productive assets and therefore non-liquid or not easily repatriated. Much of the expected outflow is likely to come from a small group of top host economies of United States outward stock, including a number of offshore financial centers (figure 5). Looking only at holdings of liquid assets, the largest portion (almost 40%) of funds available for repatriation appear to be located in the United Kingdom and its offshore territories.⁶

The impact of funds repatriations on actual investment in the United States is the great unknown. The 2005 HIA has been widely criticized as a “windfall” for MNEs and their shareholders, which did not lead to significant additional capital expenditures and jobs. Current expectations are again that a significant part of the funds will either be returned to shareholders through dividends or share buy-backs, spent on M&As (which do not lead to

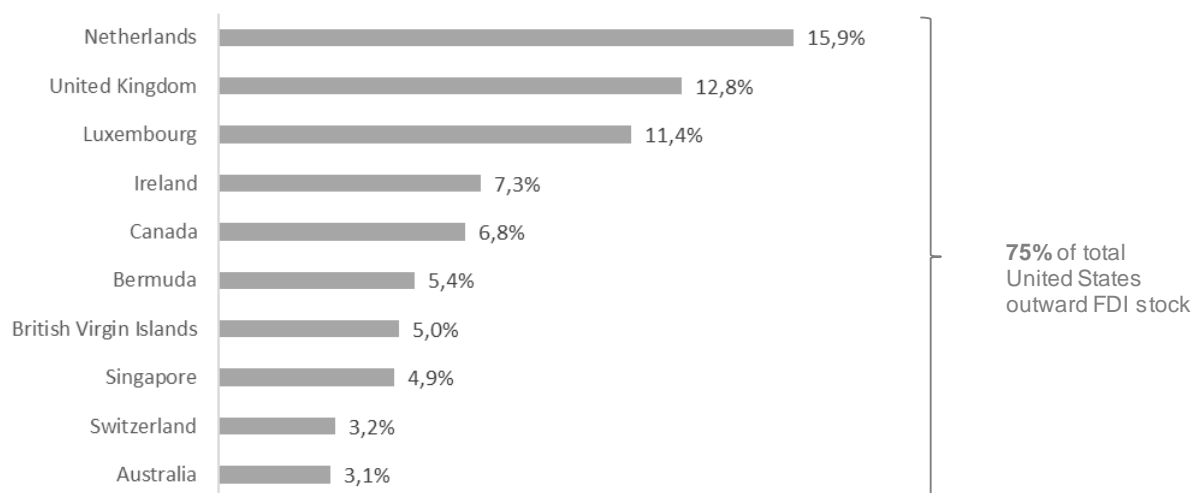
⁴ Financial analysts assume that a large part of overseas funds are already in dollars and in United States financial institutions, limiting the impact.

⁵ See Bloomberg.com, 2017 overseas profits.

⁶ Bureau of Economic Analysis data on cash holdings of majority-owned United States foreign affiliates, 2015.

immediate investment in additional productive capacity), or used for debt reductions or higher pension contributions. Projections for the actual stimulus effect vary wildly, with proponents of the reform predicting significant new investment, and others (including the Federal Reserve in its projections underpinning monetary policy) adopting a more cautious stance. It should be noted that the 2005 HIA was not accompanied by other reforms, such as the full deductibility of investments in capital equipment. The combined effect of measures to bring back cash and to invest in productive assets may well be more positive.

Figure 5. Top 10 locations of United States outward FDI stock, 2016



Source: UNCTAD FDI database.

The tax reform package includes further measures to persuade MNEs to bring back certain assets and activities to the United States, and at the same time to combat tax avoidance and erosion of the tax base in the United States.

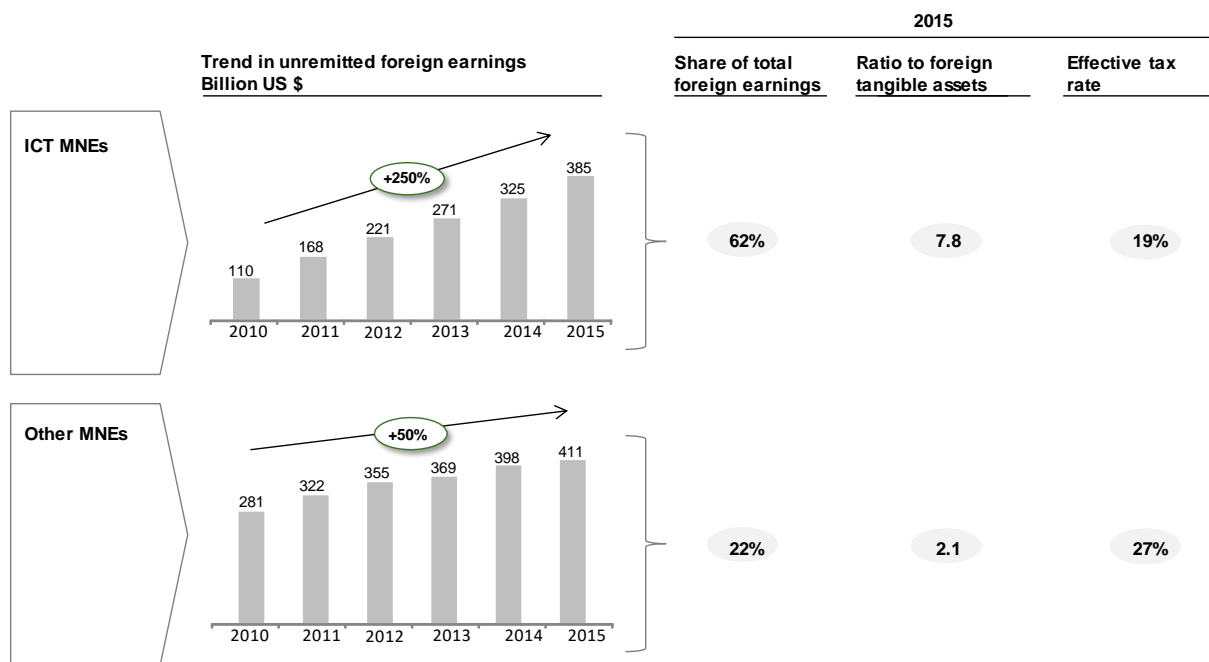
A key measure aimed at MNEs that hold intangible assets and intellectual property (IP) overseas for the purpose of booking profits from royalties in lower tax jurisdictions is the global intangible low-taxed income (aptly-named GILTI) regime and the foreign-derived intangible income (FDII) rules. The GILTI rules impose a minimum tax on the part of a United States MNE's foreign earnings that exceeds a standard rate of return on tangible assets.⁷ The FDII rules have elements in common with patent boxes;⁸ they grant a reduced tax rate on income from intangibles where the income is derived from exports of IP and services. In combination, the rules aim to ensure that MNEs cannot erode the tax base in the United States by strategically locating (often United-States produced) IP in low-tax jurisdictions, and to provide an incentive to keep IP (and associated R&D) in the United States for exports.

The effects of these measures will be felt by "the most GILTI MNEs", including high-tech and pharmaceutical firms. Tech MNEs, in particular, will be affected. Figure 5 (from *WIR17* on Investment and the Digital Economy) shows how tech MNEs in UNCTAD's Top 100 MNEs have accumulated foreign retained earnings at a rate five times faster than other MNEs. Their overseas retained cash holdings are almost eight times their tangible assets, compared to two times for other MNEs. And their global AETR is significantly lower.

The practice of using cross-border royalty payments for base erosion and profit shifting (BEPS) purposes is common to all industries. But data from the Bureau of Economic Analysis (for 2014) shows that of \$60 billion worth of payments between foreign affiliates across all industries, \$35 billion is accounted for by affiliates of tech MNEs alone. The GILTI and FDII measures could lead to changes in practices and international corporate structures in United States MNEs, with the associated re-routing of FDI positions.

⁷ These measures affect the global earnings of United States MNEs. Therefore, the resulting overall United States international tax regime could be considered less than fully territorial.

⁸ Questions have been raised regarding the consistency of the new rules with BEPS Action 5 guidelines.

Figure 6. Unremitted foreign earnings of United States MNEs in UNCTAD's Top 100 MNEs


Source: World Investment Report 2017.

The reform package also aims to tackle other types of erosion of the tax base in the United States. The bill includes a base erosion anti-abuse tax (BEAT), which is an alternative minimum tax designed to curtail excessive earnings stripping through payments to foreign related parties. The BEAT is levied only on large groups (with at least \$500 million annual revenues) and it imposes a 10 per cent tax on certain defined payments to related parties abroad – or overseas affiliates in the MNE network. Such payments could include interest payments, insurance premiums, management fees, and other types of payments that are often used for BEPS purposes. (It does not apply to payments for inventory included in cost of goods sold, a controversial measure that had been considered and that would have had a significant negative effect on global value chains.) The BEAT measure could lead to affiliates in the United States of foreign MNEs paying more tax under the new regime, despite the reduction in the statutory CIT rate.

Conclusions

The overview of tax reform measures relevant for international investment provide here is necessarily succinct and incomplete. It does not consider all detailed provisions and measures applicable to specific industries. Specific measures have been adopted affecting, for example, the energy sector and the financial sector, which could also have implications for cross-border investment.

The discussion also does not take into account broader macro-economic effects. Increased budget deficits due to the tax cuts could affect interest rates and the investment climate. Decisions by the Federal Reserve could offset the fiscal stimulus. And developments in other policy areas, notably international trade, would have a strong impact on the activities of MNEs and on international investment.

The outcomes will also very much depend on reactions in other countries. For example, China has recently put in place measures to encourage reinvestment by foreign MNEs in its territory. Also, with the move to a territorial tax system the motivation to engage in a degree of tax competition increases for United States trade and investment partners that are small open economies (not offshore economies). In fact, a number of countries have recently announced cuts in CIT rates. Increased tax competition could have a negative impact especially on lower-income countries, where corporate income taxes are more important for government revenues and rates are still relatively high.

Investors will face some uncertainty as the detailed effects of the tax reform bill are clarified, and as they wait to see how other countries, including United States tax treaty partners, react to some of the measures. Concerns have

been raised that provisions in the reform bill may violate United States double taxation treaties (DTTs) and trade rules.⁹

What seems clear from this overview is that global investment patterns could see important developments over the coming period, as the full implications and workings of the tax reform bill become clear:

- Repatriation of overseas funds, possibly to the tune of almost \$2 trillion, will lead to negative outflows, and a sharp reduction of United States outward stock (and inward stocks elsewhere).
- The removal of the need to keep earnings overseas could lead to structurally lower retained earnings in foreign affiliates of United States MNEs.
- This, combined with the anti-avoidance measures, could lead to a re-routing of FDI links in the international corporate structures of United States MNEs.
- The greater degree of freedom in the use of overseas cash might lead to a further increase in M&As (although perhaps more domestic M&As than cross-border M&As), but the curbs on interest deductibility might dampen this effect.
- The stimulus to investment in the United States provided by a lower CIT rate and full investment expensing might lead to higher inward investment in the United States, and possibly to further re-shoring of manufacturing activity.

The tax reform bill has been, and is, controversial in many quarters, and the ultimate effect of the measures contained in it is hard to predict. The intent of the combination of provisions is clear: to bring back overseas funds of United States MNEs and to stimulate the investment of these funds in productive assets. Equally clear is that the reform package will have significant implications for global FDI patterns over the coming years.

⁹ European finance ministers alerted the United States administration that tax plans could be inconsistent with international agreements and trade rules. Reuters, 11 December 2017.



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