Research Article

International Journal for Public Policy, Law and Development

Volume 2, Issue 4, Year 2025

U.S. Tax Reform: "The Four Ages Of U.S. International Tax"

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Received: 20-08-2025, Manuscript No. JQR/IJPLD/66; Editor Assigned: 21-08-2025, Manuscript No. JQR/IJPLD/66; Reviewed: 27-08-2025, Manuscript No. JQR/IJPLD/66; Published: 31-08-2025

Abstract:

This article traces the evolution of the U.S. international tax regime across four distinct historical periods: the age of benefits (1918–1960), the age of neutrality (1960–1980), the age of competition (1981–1997), and the age of cooperation (post-1998). It examines how foundational principles such as capital export neutrality, residence-based taxation, and anti-deferral measures have shaped legislative enactments from the Foreign Tax Credit of 1918 through the Tax Cuts and Jobs Act of 2017. While the framework has succeeded in balancing double taxation relief and U.S. business competitiveness, longstanding features like deferral and check the box elections have facilitated base erosion. The paper highlights the resilience of these core structures despite global reforms, questioning whether the U.S. approach remains optimal amid OECD Pillar Two's push for minimum taxes. The study provides essential context for understanding current debates on aligning U.S. tax policy with global standards.

Keywords: U.S. International Taxation, Capital Export Neutrality, Deferral, GILTI, Pillar Two, BEPS, TCJA

1. Introduction

The original intent of the U.S. International Tax Law

The U.S. Congress permitted taxation of income "from whatever source derived," with the Sixteenth Amendment of 25 February 1913. Congress subsequently approved the taxation of net income of individuals and corporations on October 3, the same year. In its early years, (between 1913 and 1918) pre–Thomas Sewall Adams, U.S. income tax law permitted only a deduction of tax expenses incurred to foreign governments. For the first time anywhere the world over, the U.S. Revenue Act of 1918 enacted a credit for foreign taxes paid by a U.S. citizen or resident against their U.S. tax payable[1]

The Revenue Act of 1921 introduced a limit on the foreign tax credit (FTC) claimable ensuring that total FTC does not exceed U.S. tax payable on the same foreign income. The FTC application has changed over time nonetheless, the two provisions enacting and limiting the FTC form basis of the law for taxing foreign income earned by U.S. citizens and residents in the U.S.[2]

The League of Nations released draft model bilateral income tax treaties in 1928. The model bilateral income tax treaties served the purpose for reciprocation of relief for double taxation of cross border income. The League of Nations model still exists today and serves as the foundation for the OECD Model Tax Convention, the UN, and the U.S. Models. Consequently, the U.S. international tax regime was formulated during the period between 1919 and 1928 decade and regardless of the economic developments, it remains intact and to date governs the income tax implications of international business.[3]

2. The Four Ages

The U.S. international taxation history can be divided into four periods based on the theoretical underlying principle influencing the periodical legislative enactments[4]

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Age of Benefits

The initial period, known as the age of benefits, began in 1918 during the emergency and adoption of the Foreign Tax Credit and lasted to 1960 (the end of the Eisenhower Administration). This period was mainly characterized by the principle of right to tax as emanating from taxing state benefits.[5]

Age of Neutrality

The next phase, known as the age of neutrality, had residence-based taxation as its main focus. and was underpinned by the capital export neutrality notion. This thrived from 1960 up to the end of Carter Administration.[6]

Age of competition

The third phase, known as the age of competition, is anchored on the need to leverage the U.S. economy competitiveness on the global marketplace, emphasized on source-based taxation and this period lasted from 1981 to 1997.[7]

Age of cooperation

The fourth period, commonly known as the age of cooperation, involved an increased effort to cooperate with the OECD project of 1998 on harmful tax competition. This period is characterized by efforts to harmonize the U.S. tax system with the OECD harmful tax guidelines on the avoidance of double taxation and or non-taxation through interfuse of residence and source taxation.[8]

The three main takeaways from the U.S. International Tax history, up to 2017, are:

1. There has not been real change in the last 100 years. Like any other system, the U.S. international taxation is anchored by the desire to prevent double taxation while balancing the need to forbid non taxation while upholding the U.S. businesses competitiveness on the global marketplace.
2. There has been back and forth on residence and source-based taxation with little or no shift on the underlying balance, and
3. The U.S. will not likely make a clean break from its history by either abolishing all source-based taxation for non-U.S. persons or all residence-based taxation for U.S. citizens.[9]

3. <u>Making Sense of the U.S. International Taxation</u>

Data Avi-Yonah points out that there are two fundamental principles underlying the U.S. international tax regime. These are the single tax principle and benefits principle. The single tax principle dictates that foreign earned income should be taxed only once while the benefits principle dictates that the rate of tax imposed on foreign income should be determined by the income type (either active or passive). The benefits principle further entails that active income should primarily be subject to source taxation while passive income should be primarily taxed on residence basis.[10]

Avi-Yonah further postulates that the core structure of the U.S. international taxation is perceived to reflect these two principles with the U.S. classifying the world into two categories namely “U.S. persons” and “non-U.S. persons.” The U.S. persons being taxed on their worldwide income and non-U.S. persons only taxable up to the extent of their U.S. source income. In both cases, tax rules are dependent on whether the income is active or passive.[11]

Avi-Yonah further points out that for non-U.S. persons passive U.S. source income is taxed at gross under the withholding tax regime while the respective active income is taxable net of operating expenses. For the counterparts (U.S. persons), passive income is taxable while the active income enjoyed benefits of the deferral schemes and or exemption.[12]

4. <u>Territorial versus. Worldwide Taxation System</u>

The U.S. operated a worldwide taxation system for American resident corporations. The American worldwide approach to taxation was commonly known as the resident-based tax system. On the other hand, the alternative to resident-based taxation is a source-based system also referred to as a territorial system. The territorial systems entail that the U.S. will only be able to tax American corporations on their American earned income alone i.e., limited to income earned within American physical borders.[13]

A clear cut between territorial and or a worldwide system poses a challenge on a nation’s ability to curb tax avoidance schemes of MNEs and consequently would encourage harmful tax competition amongst countries. In real life there is no absolute distinction between a territorial and worldwide tax system. Nonetheless, an absolute worldwide system would manifest the concept of capital export neutrality. Capital export neutrality means that investors are indifferent about investing at home or abroad regarding taxes.[14]

On the other hand, an absolute territorial system would manifest in the concept of capital import neutrality, also referred to as competitive neutrality. This means that foreign investors establishing their investments in other countries will deal with the same tax consequences as the local (foreign) competitors on their local (foreign) markets. This then means that there are no tax competitive advantages awarded to foreign investors in foreign markets.[15]

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However, there is a third concept of neutrality commonly known as national neutrality. This entails a worldwide taxation system which allows for a deduction of foreign taxes paid as opposed to granting full foreign tax credits. Allowing a deduction over a credit disincentivizes foreign investments as allowing a deduction reduces the after-tax return of foreign investments. It follows that a credit is more costly to the government than a deduction from a government revenue raising standpoint.[16]

According to Michael O'Hear, from a U.S. perspective, national neutrality means that the U.S. tax policy should be inclined towards investing in the U.S. over investing in equally productive foreign destinations. Under such, the U.S. will enjoy the pre-tax earnings on domestic investment in the form of other taxes and after-tax income distribution to private residents.[17]

5. Dysfunction of the American Tax System

Prior to the introduction of TCJA (2017), the U.S. employed a system that taxed income earned within its borders (by both resident and foreign corporations) and worldwide income of U.S. resident corporations. Nonetheless, the U.S. system did not tax foreign income earned by U.S. owned corporations chartered abroad "Controlled Foreign Corporations" (CFCs).[18]

Despite the U.S. having a worldwide tax system, the system allowed U.S. MNEs with CFCs to delay paying taxes on the foreign income earned through subsidiaries (through the deferral system) until at the point of repatriation of the income (to the U.S.). In a worst case scenario, U.S. MNEs could completely avoid U.S. tax through the deferral scheme if they never opt to repatriate the foreign earned income. Nonetheless, foreign income earned through branches of U.S. MNEs could not be deferred. This also applies to passive income earned through both branches and subsidiaries abroad i.e., interest, royalties, rents, dividends, and annuities.[19]

Therefore, a U.S. corporation could defer U.S. taxation where it operates through a CFC subsidiary. U.S. taxes could be deferred indefinitely by a U.S. corporation if the income earned through its CFC is reinvested abroad. However, with some exceptions, U.S. tax was only applicable where the income is remitted to the U.S. holding company. Remittance may take the form of dividends and or royalties and interest paid intra company.[20]

6. Analysis of the U.S. Taxation Concepts (pre- 2017)

6.1 The U.S. Controlled Foreign Corporation (CFC) Regime

CFC rules were introduced 1962 in the U.S. and making it the first country to establish such a regime. The rationale of the CFC regime was to limit deferral of passive income earned in foreign subsidiaries such as interest, royalties, and dividends.[21] The idea of the CFC concept is for the regime to stand as an anti-avoidance measure meant to prevent deferral and or shifting of profits to subsidiaries in low tax jurisdictions. The CFC rules are supposed to detect income of the foreign subsidiary escaping the taxation and bringing it into the tax net.[22] However, the U.S. CFC regime proved otherwise. The regime demonstrated a lack of effectiveness in several ways. The U.S. CFC regime comes with several exceptions which include but not limited to the check the box regime which consequently disabled its effectiveness.[23] Another exception to the U.S. CFC regime was known as the "manufacturing exclusion" and was meant to exclude income from manufacturing activities of a CFC that added "substantial value to goods." The exception was relaxed in 2008 and made less stringent to open doors to non-manufacturers i.e., contract manufacturers who would be deemed to make "substantial contribution" to the goods.[24]

6.2 The U.S. Deferral

The deferral feature of the U.S. tax system undermines the effectiveness of U.S. tax impact on foreign sourced income in a way that reinforces the territoriality notion to the system. Deferral creates a clear separation in the U.S. taxation structure for foreign sourced income i.e., deferral for foreign subsidiary income and normal corporate taxation for foreign branch income. Most of U.S. foreign investments generating active income are managed through CFCs.[25] Deferral calls for heightened significance for the system's rules governing the shifting of income between related parties. Especially where proper and careful tax planning on the destination where profits can be assigned results in a lowered overall tax burden. The current system relies heavily on transfer pricing where firms are required to set hypothetical prices which would reflect the price two unrelated parties would agree in an uncontrolled transaction to satisfy the arm's length principle. The current U.S. system is complex and uneasy to administer.[26]

6.3 Check the Box Regime

The regime came into force in 1997, and it allows foreign subsidiaries of U.S. MNEs to engage into intercompany (related party) transactions amongst themselves. Such transactions include loans, royalty payments, etc., and such transactions are disregarded for tax purposes. Check the box allowed a U.S. MNE to establish a foreign subsidiary which in turn owns its own foreign subsidiary.[27]

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The U.S. MNE (parent) would literally tick "check" a box on the IRS return opting for the lower-level subsidiary to be a disregarded (not recognized for U.S. tax purposes) pass through or fiscally transparent entity. Therefore, intercompany transactions between the two foreign subsidiaries were treated as intra company thereby avoided detection by Sub Part F (anti-deferral) rules.[28]

The intention of the regime was to unburden both taxpayers and the IRS from presumably unnecessary costs of determining classification of entities and making entity classification for tax purposes effectively elective. Nonetheless, the freedom of choice (election) created a conducive environment for serious tax avoidance by undermining the CFC rules through hybrid entities.[29]

In 2006, the U.S. further enacted the "CFC look-through rule" which specifically excluded passive income payments between two controlled foreign corporations from the CFC regime. The CFC look-through rule mirrored the effect of the check the box regime and in this instance relating to passive income.[30]

6.4 Active Financing Income

"Active financing income" is income earned by U.S. MNEs with banking, financing, and insurance operations overseas. Active financing income is a major exception to subpart F rules. Despite some of the income earned in this line of business (interest, annuities etc.) falling within passive income category, they are specifically exempt from subpart F if earned through active business activities. Therefore, income earned in active financing business activities is eligible for deferral and only taxable at the point of repatriation to the U.S.31 However, passive income would just be treated as such notwithstanding the nature of business generating it.

6.5. U.S. Transfer Pricing Rules / Treatment of Intangibles

The U.S. treasury introduced the cost sharing regime in the early 90s. Under this regime, a cost sharing agreement is drawn between a U.S. MNE and controlled foreign corporation to share research and development (RCD) costs. Profits derived from the use of the intangible asset are split on the basis of the cost sharing agreement, e.g., 30:70. If the subsidiary contributes 70 per cent of the RCD costs that, therefore, directly entails a 70% share of the profits are attributed to it.[32]

The regime effectively disabled the application of the arm's length principle of transfer pricing. U.S. MNEs exploited this tax planning opportunity by transferring intangibles to low tax jurisdictions and attributing a significant part of the RCD costs to the low tax jurisdiction subsidiary even if the RCD activities actually took place entirely in the U.S. Alternatively, the U.S. MNE would sell the intangible asset to the offshore subsidiary and put in place a licensing agreement where the offshore subsidiary pays a royalty to the U.S. parent.[33]

6.6. U.S. Unilateralism

The U.S. has a unilateralistic approach to multi-lateral agreements. Post-Cold War, the U.S. Foreign Policy proved to be very influential globally. This resulted in the U.S. participation in any international agreement attracts a wider acceptance of the agreement. Where the U.S. refrains from participating in any international agreement, the agreement remains unappealing to the wider world. This can be evidenced by the U.S. abstinence from the International Court of Justice (1986) and the Kyoto Protocol (for reduction of greenhouse emissions for climate change). This U.S. approach towards international law, also known as "instrumental multilateralism," can also be evidenced in international taxation and particularly the two concepts of cross border exchanges of information i.e., Foreign Account Tax Compliance (FATCA) and Automatic Exchange of Information (AEOI).[34]

In 2016, the U.S. made proposals, in their 2017 budget, on hybrids, IP, and interest deductions. The U.S. revised Tax Model issued in 2016 contained some of the key BEPS project concerns ranging from double non taxation to stateless income and treaty shopping.[35]

7. Reform of the American Tax System

U.S. Tax Reform

The Treatment of Intangibles
The treatment of intangibles takes center stage in international taxation of MNEs. The recent U.S. tax reform of 2017 had a special focus on intangibles. The changes to the U.S. tax law were so fundamental to the extent that they challenged the status quo that had developed and existed over time regarding control of global ETR through Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) of intangibles.[36]

OECD BEPS Actions 8 – 10 and the U.S Model Convention on Intangibles

Prior to the 2017 tax reform, U.S. MNEs employed many tactics to shift profits to low tax jurisdictions in avoiding the enormous. U.S. corporate tax. Some techniques employed by U.S. MNEs included paying for patents, royalties to offshore subsidiary, and set up of offshore IP to undermine the U.S. tax base by increasing costs and reducing taxable profits. On the other hand, increasing the low taxed offshore subsidiary revenues and profits. Transfer pricing rules were

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enacted to limit the base erosion and profit shifting activities of U.S. MNEs without much success as the laws proved less effective.[37]

However, with the introduction of the new tax act (Tax Cuts and Jobs Act), the U.S. tax law on intangibles is now aligned with the BEPS Actions 8 – 10. The focus is on aligning transfer pricing outcomes with value creation hence creation of balance in the allocation of income between routine and non-routine functions of affiliates, a serious departure from the cost contribution arrangement basis of allocating profits. Defining of offshore low taxed income (GILTI) and the U.S. deemed intangible income (FDII) provisions are intended to incentivize economic activity in the U.S. over other nations.[38]

The Tax Cuts and Jobs Act

The U.S. tax reform of 2017, also known as the Trump tax reform, introduced the Tax Cuts and Jobs Act (TCJA). The 2017 TCJA saw a raft of sweeping changes in the U.S. international tax law. Noteworthy was the tremendous reduction of the maximum domestic tax rate for corporate taxpayers from the significant 35% to as little as 21% effective 2018. From an international perspective, the TCJA:

- upheld the hybrid territorial system,
- sought to counter base erosion to fortify the U.S. tax base from cross border base eroding payments,
- sought to set U.S. as an attractive investment base ahead of other nations (a nationalistic philosophy of the Trump regime) at an attractively low global ETR.[39]

The TCJA also saw changes in the definition of intangibles in the U.S. tax code in order to validate the IRS preferred valuation methods which were previously challenged by the national courts.[40]

Key Provisions of the TCJA

The TCJA is a reflection of the U.S. stance toward the OECD BEPS project. Similar to many other world's leading economies e.g., the EU bloc, the UK and Australia, the TCJA changes sought to address the OECD BEPS fundamental issues from a unilateral standpoint. This is evidenced by the number of provisions governing cross border activity on outbound and inbound activities in the U.S. which in turn has a bearing on the ETR schemes of MNEs with activities within the U.S. These provisions strikingly resemble the OECD BEPS project Pillar 2.[41]

The U.S. also moved from a worldwide tax system to a hybrid territorial one. The hybrid aspect of the territoriality arises from the maintenance of the CFC provisions within the law though with some changes.[42]

(i) Subpart F Income

To curb tax avoidance by MNEs moving passive income into tax havens, Subpart F limits the use of deferral in certain instances. According to Subpart F rules, U.S. holding companies of CFCs are subjected to current taxes in the U.S. on some of its subsidiary income notwithstanding deferral i.e., U.S. MNEs pay taxes on Subpart F income in the year of accrual despite actual repatriation or not.

Subpart F rules entail that shareholders owning at least 10% of the foreign corporation (subsidiary) stock and only foreign corporations that are owned at least 50% (i.e., controlled foreign corporations) by 10% U.S. shareholders are subject to its application by taxing of passive and other mobile categories of income e.g.:

- foreign personal holding company income;
- certain insurance income, and;
- related-party sales or services income in the year the income is earned.

Subpart F curtails the deferral advantage otherwise available to multinationals that shift profits into low-tax jurisdictions. Territorial tax systems generally come with some sort of anti-abuse rules to curb tax avoidance by MNEs.[43]

(ii) Global Intangible Low Taxed Income (GILTI)

Post the Trump reform, the U.S. allowed for income derived from active business of U.S. MNEs offshore subsidiaries to be exempted from tax even at repatriation. Nonetheless, to disincentivize base erosion and profits shifting to low taxed offshore jurisdictions, the U.S. introduced 10.5% minimum (so called 50 – 50 tax i.e., 50% of U.S. new CIT rate of 21%) on global intangible low taxed income.[44]

GILTI is arrived at by calculating the income earned from offshore subsidiaries that is in excess of 10% of the MNE's depreciable tangible assets (QBAI). Foreign tax credits are claimed up to 80% for foreign taxes paid/accrued on the GILTI and claimable only on 50% of the total GILTI.[45]

Both Subpart F and GILTI recognize that income already taxed abroad above a "high-tax" threshold (high tax exclusions), currently 18.9 per cent, i.e. 90 per cent of the 21 per cent U.S. headline rate, should not trigger an additional U.S. inclusion.[46]

CITE THIS ARTICLE: Muchimbidzi , L. T. . (2025). U.S. Tax Reform: "The Four Ages Of U.S. International Tax". International Journal for Public Policy, Law and Development, 2(4), 32-29. https://ijpld.com/ijpld/article/view/66

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(iii) Foreign Derived Intangible Income (FDII)

The FDII is meant to incentivize U.S. MNEs to have their business activities performed in the U.S. and services and goods exported to foreign countries. A fixed rate of return is established by calculating a baseline 10% rate on a company's depreciable assets or qualified business asset investment (QBAI). Excess income to the baseline is analyzed to determine the foreign derived portion. The foreign derived element of the income is the MNE's FDII for the period. FDII is taxed at a lower rate of 13.12 percent as compared to the U.S. standard corporate tax rate of 21 percent.[47]

(iv) Base Erosion and Anti-Abuse Tax (BEAT)

Base erosion and anti-abuse tax apply to U.S. and as well non-U.S. MNEs. The purpose of BEAT is the imposition of a 10% minimum tax (rising to 12.5 percent after 2025) on "modified taxable income (MTI)". MTI is the taxable income increased by the full amount of deductions generated by base erosion payments to related parties as result of the base erosion payments being in excess of 3% of total allowable tax deductions (including Net Operating Losses). This tax fits quite well into the profit split model of the TCJA on U.S. combined income. This tax is a base protection measure similar to that of the UK (Diverted Profits Tax). The BEAT has an impact on MNEs that have base erosion (through foreign payments to related parties in low tax jurisdictions) as part of the ETR reduction scheme.[48]

Base Erosion Payments are payments or accruals to foreign related persons where deduction is allowable for U.S. tax purposes. The base erosion payments normally involve payment for:

- Interest,
- Royalties,
- Cost sharing agreement payments,
- Service and management fees, etc.[49]

U.S. Position versus OECD Pillar 2 GloBE rules

While the historical progression of the U.S. international tax system reveals a pragmatic balance of residence and source taxation, it also raises pressing questions under the emerging OECD Pillar Two framework. The continued reliance on a hybrid worldwide approach, with features like GILTI and limited foreign tax credits, may become increasingly misaligned with global norms as other jurisdictions adopt standardized minimum taxes.50 This could pose competitive risks for U.S. multinationals, potentially subjecting them to overlapping tax burdens. For example, where U.S. tax on foreign income is deferred or partially offset through GILTI's reduced inclusion and credit limitations, other countries implementing Pillar Two top-up taxes may impose additional levies, leading to effective double taxation on the same cross-border earnings.[51]

This layering of taxes undermines neutrality and could discourage U.S. firms from expanding or maintaining foreign operations, or conversely prompt foreign subsidiaries to restructure to avoid multiple jurisdictions' top-ups.52 Moreover, retaining unilateral features might deter inbound investment or encourage U.S. based firms to relocate intellectual property or headquarters to jurisdictions with simpler, purely territorial systems. Policymakers must weigh whether sustaining these unique anti-deferral measures and hybrid rules optimally secures the tax base, or if closer alignment with multilateral minimum tax standards would better safeguard competitiveness and revenue stability.53 This analysis highlights the need for future reforms that reconcile long standing U.S. tax principles with the practical challenges of an increasingly coordinated global tax environment.[54]

Current Developments

Following the Tax Cuts and Jobs Act, recent developments have further reshaped the U.S. international tax landscape. The Inflation Reduction Act of 2022 introduced a new 15% Corporate Alternative Minimum Tax (CAMT), calculated on adjusted financial statement income.55 However, this CAMT does not qualify as a GloBE compliant Qualified Domestic Minimum Top-up Tax (QDMTT) under OECD Pillar Two rules.56 As a result, U.S. multinationals may still face foreign top-up taxes imposed by other countries under their income inclusion rules or undertaxed profits rules.[57]

This lack of alignment has driven renewed international negotiations. Recently, a side-by- side compromise deal was discussed among G7 finance ministers and the U.S., aiming to coordinate how the U.S. domestic minimum taxes like the GILTI and foreign GloBE rules could coexist without excessive double taxation.[58] This emerging framework suggests that the U.S. may preserve some aspects of its existing system while agreeing on mutual recognition mechanisms or safe harbors to protect U.S. multinationals from overlapping top-ups.[59] Policymakers should continue to evaluate how to adapt GILTI, or adopt complementary measures that align with Pillar Two, balancing U.S. tax sovereignty with global efforts to curb base erosion.[60]

8. Conclusion s Policy Outlook

The U.S. international tax system has evolved through incremental adaptations rather than fundamental redesigns, maintaining a delicate equilibrium between residence and source taxation while preventing double non-taxation. Yet mechanisms like deferral and hybrid entity elections have historically undermined tax neutrality, inviting aggressive tax

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planning. As global initiatives such as the OECD Pillar Two minimum tax reshape the international landscape, the United States faces mounting pressure to align its corporate tax regime with multilateral norms. Policymakers must grapple with how to preserve U.S. competitiveness without perpetuating incentives for profit shifting. Future reforms should critically examine legacy provisions, such as the remaining deferral privileges, and strengthen anti-avoidance rules to ensure that taxing rights are more closely aligned with value creation. In doing so, the U.S. can uphold both its fiscal interests and its leadership role in advancing fair and efficient international tax standards.

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