

U.S. Corporate Tax Cuts and Trade War Tariffs on Multinational Firms' Foreign Income

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Abstract: *This study examines the combined effects of U.S. corporate tax cuts and trade war tariffs on the foreign income of multinational enterprises (MNEs) from 2015 to 2019. Using firm-level data, the analysis shows that lower corporate tax rates did not reduce profit shifting abroad. Instead, in industries highly exposed to import tariffs, tax savings were used as financial buffers against tariff-related costs rather than for domestic reinvestment. The results indicate that the effectiveness of tax cuts diminishes when paired with protectionist trade policies. These findings suggest that fiscal and trade policies must be designed in an integrated manner to support multinational competitiveness during periods of geopolitical and economic uncertainty.*

Keywords: Corporate Tax Policy; Trade Protectionism; Foreign Income Allocation.

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1. Introduction

The interaction between U.S. tax reform and international trade tensions has generated significant academic debate (Acemoglu and Restrepo, 2022). The Tax Cuts and Jobs Act (TCJA) of 2017 lowered corporate tax rates with the intention of stimulating domestic investment. At the same time, the escalation of the U.S.–China trade war introduced tariff shocks that increased costs for many multinational enterprises. This overlap created conflicting incentives: while tax relief encouraged firms to repatriate profits, tariff-related disruptions raised the costs of global supply chains and pushed firms to seek financial flexibility abroad (Hanlon et al., 2019; Gale et al., 2020).

This raises questions about the determinants of multinational firms' foreign income allocation under conditions of simultaneous tax and trade shocks. Previous research has shown how firms engage in profit shifting to minimize tax liabilities (Grubert & Mutti, 2000; De Simone, 2016). However, less is known about how these strategies evolve when tariff-induced cost pressures coincide with domestic tax incentives. The “foreign income puzzle” emerges here: despite lower U.S. statutory tax rates, firms did not uniformly reduce foreign income dependence. In import-dependent sectors, companies adjusted their financial strategies to preserve liquidity and hedge against uncertainty (Dharmapala, 2020). This study therefore seeks to disentangle the combined effects of tax cuts and tariff shocks on multinational income allocation and to highlight the limits of tax-based incentives during periods of geopolitical and economic instability.

Empirical results suggest that effective cash tax rates (ECTRs) are negatively correlated with future foreign income shares, especially in sectors highly vulnerable to import tariffs. In contrast, firms not significantly exposed to the trade war exhibit a weaker or non-significant response (Chen et al., 2023). This divergence implies that tax cuts, in isolation, may be insufficient to offset the adverse effects of trade protectionism on international earnings. Furthermore, government efforts to mitigate external shocks through corporate tax relief may have limited traction when firms prioritize operational flexibility and foreign market access over domestic reinvestment (Clausing, 2020).

Therefore, this study aims to disentangle the competing effects of tax cuts and tariff shocks on the geographical

composition of corporate earnings, focusing on U.S. multinational firms. It contributes to the literature by offering granular evidence that challenges the assumption of tax policy neutrality in the face of global uncertainty. By identifying heterogeneous firm responses conditioned by trade exposure and cash flow sensitivity, the study also informs fiscal policymakers about the limits of tax-based incentives under conditions of geopolitical risk and supply chain reconfiguration.

2. Literature Review

Recent research highlights that the current era is increasingly characterized by trends of deglobalization, in which global economic integration faces significant headwinds from rising protectionism and shifting government policies (Witt, 2019). Within this context, scholars have investigated the complex interplay between corporate tax policy and international trade shocks, often identifying contradictory outcomes for multinational enterprises.

A central puzzle following the 2017 Tax Cuts and Jobs Act (TCJA) is why many U.S. corporations have continued profit-shifting abroad despite lowered U.S. statutory tax rates (Chen et al., 2023). Traditional theory predicted that reduced tax rates would incentivize firms to repatriate profits and rely more heavily on domestic income. Contrary to these expectations, empirical studies demonstrate that this effect is not uniform, especially in sectors exposed to heightened import tariffs.

One major stream of literature examines tariff exposure and its influence on firm behavior. Feenstra, Romalis, and Schott (2002) provide a foundational analysis by compiling detailed U.S. import and tariff data at the product level, enabling researchers to link trade shocks with firm-level responses. Subsequent studies have shown that recent trade conflicts, such as the U.S.–China trade war, led to significant operational changes for manufacturing and intermediate goods producers, who faced direct cost increases and the need to reconfigure global supply chains.

Another body of work analyzes the longer-term effects of import competition on U.S. businesses and labor markets. Acemoglu et al. (2016) document how Chinese trade shocks altered employment patterns and corporate decision-making, with downstream effects on firm-level financial strategies. In these circumstances, companies appear to prioritize liquidity and international flexibility rather than increasing domestic reinvestment.

Recent empirical evidence further demonstrates the role of effective cash tax rates (CETRs) in shaping foreign income allocation. Chen, Lin, and Shao (2021) find a negative link between CETR and the share of foreign income, and this relationship is most pronounced in industries vulnerable to tariffs. In such cases, tax savings tend to be reserved for supporting international operations rather than stimulating domestic investment. Similarly, Chen et al. (2023) confirm that during periods of tariff shocks, tax reductions enable firms to sustain offshore activities without driving repatriation.

These findings are consistent with broader theories of profit shifting and tax minimization (Grubert & Mutti, 2000; Dharmapala, 2020). They further show that in volatile trade environments, firms reconfigure income strategies as a form of risk management, and foreign income reflects both tax arbitrage and active hedging against uncertainty.

Overall, the literature suggests that the effectiveness of tax reform as a stand-alone policy tool is limited. While tax cuts are intended to encourage domestic investment, their impact is diluted when protectionist trade measures are in place. As Clausing (2020) argues, multinational firms respond adaptively to both fiscal and trade pressures, so corporate tax relief alone cannot ensure reductions in profit shifting or greater domestic economic activity. This study adds to this discussion by directly examining how tax policy and tariff shocks interact to determine the foreign income allocation strategies of U.S. multinational enterprises.

3. Methodology

3.1 Data Source

This study uses firm-level panel data compiled by Chen, Lin, and Shao (2021) from the Compustat North America Fundamentals Annual database, covering the period 2015–2019. The sample includes U.S.-listed manufacturing firms classified under 6-digit NAICS industry codes. Observations with missing or implausible financial data were excluded, and industry codes were standardized to the 1997 NAICS version using U.S. Census concordance tables. To capture tariff exposure, industry-level data were drawn from U.S. tariff schedules compiled by Feenstra, Romalis, and Schott (2002). After winsorization to remove outliers, the dataset contains 3,921 firms and 27,309

firm-year observations, providing a robust basis for empirical analysis.

3.2 Variable Definition

The dependent variable is the **foreign income ratio (FI)**, defined as the share of foreign income in total income for firm i in year $t+1$. Two key independent variables measure tax avoidance:

- **Cash Effective Tax Rate (CETR)**: calculated as cash taxes paid divided by pre-tax income, truncated between 0 and 1. This serves as a proxy for realized tax savings.
- **Residual Book–Tax Differences (DDBTD)**: adjusted for earnings management, capturing more aggressive tax planning behavior.

Control variables include firm size, leverage, R&D intensity, capital expenditures, property, plant, and equipment (PPE), and market-to-book ratio. These controls account for firm heterogeneity in financial structure, innovation, and growth opportunities. The detailed variable explanations are shown in Table 1

Table 1: Variable Definition

Variable	Description	Measurement / Construction
FI	Dependent variable	Share of foreign income in total income \div total assets of firm i in year $t+1$
CETR	Key independent variable	Cash taxes paid \div pre-tax income (truncated between 0 and 1)
DDBTD	Captures aggressive tax planning beyond normal earnings management	Adjusted book–tax differences, controlling for earnings management
Size	Proxy for firm size, controlling for scale effects	Natural log of total assets
MB	Proxies market expectations and valuation premium	(Total assets – Common equity + Shares outstanding \times Share price) \div total assets
RD	Reflects innovation intensity and research focus	R&D expenditures \div total assets
PPE	Capital intensity	Property, plant, and equipment \div total assets
CAPXAT	Investment scale	Capital expenditures \div total assets
Tariff Exposure	Trade policy shock variable	Industry-level import tariff schedules

3.3 Regression Function

We estimate a panel fixed effect regression to examine whether corporate tax reduction affects foreign income, and how this relationship is moderated by tariff exposure:

$$FI_{it} = \beta_0 + \beta_1 * Tax\ reduction_{i,t-1} + \beta * controls_{t-1} + \mu_i + v_t + \varepsilon_t$$

Where:

- $FI_{i,t}$ represents the foreign income ratio of firm i in year $t+1$.
- $Tax\ reduction_{i,t-1}$ refers to firm-level tax avoidance measures, proxied by CETR or DDBTD. The lagged value is used for solving the endogeneity problem.
- $controls_{t-1}$ includes control variables such as leverage, R&D intensity, firm size, and other firm characteristics.
- $\mu_i + v_t$ are industry and year fixed effects, respectively.
- ε_t is the error term.

This model tests both the direct impact of tax policy on multinational outcomes and its conditional dependence on trade exposure.

3.4 Descriptive Statistics

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
fi	2,358	0.03	0.04	-0.19	0.48
cetr	2,358	0.26	0.20	0.00	1.00
ddbtd	2,358	-0.01	0.47	-7.83	7.28
size	2,358	7.42	2.22	-0.07	13.89
mb	2,358	2.49	1.88	0.24	28.64
rd	2,358	0.05	0.07	-0.01	0.95
ppe	2,358	0.43	0.32	0.00	2.57
capxat	2,358	0.04	0.03	0.00	0.30

Table 2 provides summary statistics for the main variables across 2,358 firm-year observations. The mean foreign income ratio (FI) is 0.03, with considerable dispersion (min -0.19, max 0.48), reflecting heterogeneity in international operations. The average CETR is 0.26, with a standard deviation of 0.20, indicating substantial cross-firm variation in tax burdens. DDBTD values cluster around zero (mean -0.01) but span a wide range (-7.83 to 7.28), capturing diverse tax planning practices.

Firm size varies widely (mean 7.42, min -0.07, max 13.89), and MB has a right-skewed distribution (mean 2.49, max 28.64), highlighting variability in firm scale and growth prospects. R&D intensity averages 0.05, but some firms invest very heavily in innovation (max 0.95). PPE and CAPXAT statistics reveal diversity in capital and investment intensity across the sample

4. Research Results and Discussions

This section presents the empirical findings of our analysis.

4.1 Baseline Findings

Table 3 reports the baseline panel regression results.

Table 3: Baseline Regression

VARIABLES	(1) Fixed effect fi	(2) fi
L.cetr	-0.0194*** (0.00562)	
L.size	0.00819*** (0.000549)	0.00817*** (0.000556)
L.mb	0.00185* (0.00102)	0.00203** (0.00103)
L.rd	-0.0671** (0.0270)	-0.0592** (0.0270)
L.ppe	0.00211 (0.00511)	0.00294 (0.00508)
L.capxat	0.0397 (0.0502)	0.0439 (0.0507)
L.ddbtd		0.000104 (0.00238)
Constant	-0.0637*** (0.00821)	-0.0707*** (0.00789)
Time fixed	YES	YES
Industry fixed	YES	YES
Observations	1,468	1,468
R-squared	0.452	0.447

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

The key independent variable, lagged cash effective tax rate (L.cetr), exhibits a statistically significant negative coefficient ($\beta = -0.0194$, $p < 0.01$). This indicates that a one-unit decrease in CETR (representing higher tax avoidance) is associated with a 1.94 percentage point increase in the foreign income ratio in the following year. Such findings provide direct evidence that U.S. multinational firms, even after the implementation of the Tax Cuts and Jobs Act, continue to engage in profit-shifting strategies in the face of lower effective tax rates. This behavior is consistent with prior literature, which suggests that tax minimization enhances operational flexibility, allowing firms to allocate more resources to international markets rather than repatriating profits for domestic reinvestment.

All regressions include firm-level control variables: firm size, market-to-book ratio, R&D intensity, capital intensity, and investment scale. Among these controls, firm size and market-to-book display positive and significant relationships with foreign income ratio, underscoring that larger and higher-valued firms are more likely to generate income abroad. R&D intensity holds a significant negative association, indicating that firms more focused on innovation may direct relatively fewer resources overseas. The inclusion of these controls helps account for cross-firm heterogeneity and ensures the robustness of the main findings.

4.2 Tariff Exposure as a Moderator: Amplified Effects in High-Import Industries

Table 4 investigates the moderating effect of exposure to import tariffs. The sample is split by tariff sensitivity, comparing firms operating in high-import industries against those with lower exposure.

Table 4: Subgroup Regression- Exposure to import tariffs

VARIABLES	(1) high1 fi	(2) high2 fi	(3) nohigh1 fi	(4) nohigh2 fi
L.cetr	-0.0441*** (0.0148)		-0.00665 (0.00598)	
L.size	0.00799*** (0.00103)	0.00764*** (0.00106)	0.00674*** (0.000483)	0.00673*** (0.000484)
L.mb	0.0106*** (0.00338)	0.0107*** (0.00367)	0.000644 (0.000864)	0.000700 (0.000871)
L.rd	0.116** (0.0499)	0.156*** (0.0556)	-0.0275 (0.0300)	-0.0265 (0.0293)
L.ppe	0.0207** (0.00977)	0.0210** (0.00944)	-0.0170*** (0.00423)	-0.0171*** (0.00423)
L.capxat	0.0612 (0.128)	0.0790 (0.131)	0.131*** (0.0466)	0.134*** (0.0465)
L.ddbtd		0.0194 (0.0177)		-0.000459 (0.00296)
Constant	-0.0469*** (0.00946)	-0.0570*** (0.00979)	-0.0194*** (0.00526)	-0.0215*** (0.00491)
Time fixed	YES	YES	YES	YES
Industry fixed	NO	NO	NO	NO
Observations	309	309	1,159	1,159
R-squared	0.365	0.348	0.154	0.153

Robust standard errors in parentheses

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

For firms highly exposed to import tariffs, the coefficient of L.cetr is -0.0441 ($p < 0.01$), more than double the effect seen in the full sample. This statistically significant result reveals that, in the context of increased trade protection and rising input costs, tax savings are not merely used for profit shifting—they become vital financial buffers. Firms leverage tax savings to absorb tariff-induced cost shocks, invest in alternative sourcing, or restructure supply chains globally. By contrast, firms in sectors with limited or no exposure to tariffs show an insignificant relationship between CETR and foreign income ratio ($\beta = -0.00665$, not significant). This difference suggests that the effectiveness of tax cuts in altering foreign income trajectories is highly contingent on broader trade policy. Policy incentives encouraging domestic reinvestment lose efficacy where external shocks, such as tariffs, fundamentally reshape cost structures and strategic priorities.

4.3 Trade War and Tariff Increase

Table 5 examines how firms fared during the US-China trade war by comparing those that suffered from direct tariff increases with those that did not.

Table 5: Firms suffered from the US-China Trade War.

VARIABLES	(1) No Tariff increase fi	(2) Tariff increase fi	(3) No Tariff increase fi	(4) Tariff increase fi
L.cetr	0.0308 (0.103)	-0.0193*** (0.00566)		
L.size	0.0576*** (0.00694)	0.00811*** (0.000551)	0.0574*** (0.00635)	0.00808*** (0.000558)
L.mb	-0.0206 (0.0132)	0.00188* (0.00102)	-0.0246*** (0.00501)	0.00205** (0.00104)
L.rd	5.740*** (1.364)	-0.0674** (0.0270)	6.231*** (1.136)	-0.0594** (0.0270)
L.ppe	0.344** (0.115)	0.00223 (0.00511)	0.332** (0.122)	0.00304 (0.00508)
L.capxat	-2.564* (1.186)	0.0338 (0.0503)	-2.699** (0.880)	0.0376 (0.0508)
L.ddbtd			-0.0363 (0.111)	0.000122 (0.00238)
Constant	-0.381** (0.109)	-0.0630*** (0.00818)	-0.343*** (0.0724)	-0.0698*** (0.00787)
Time fixed	YES	YES	YES	YES
Industry fixed	YES	YES	YES	YES
Observations	16	1,452	16	1,452
R-squared	0.963	0.437	0.963	0.432

Robust standard errors in parentheses

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 5 compares firms directly affected by US-China tariff increases to those that were not. For tariff-exempt firms, the lagged CETR continues to show a significant negative effect on foreign income ratios ($\beta = -0.0193$, $p < 0.01$), highlighting the ongoing use of tax minimization as a tool for international expansion and competitiveness. Tariff-affected firms, however, display a positive but statistically insignificant coefficient for L.cetr. This null result demonstrates that once trade restrictions become the main obstacle to foreign earnings, the marginal benefits of reduced tax burden diminish. As trade regulations override fiscal incentives, corporate strategies shift toward risk mitigation and supply chain resilience, limiting the direct channel from tax cuts to foreign income generation.

The results for residual book-tax differences (L.ddbtd)—a proxy for aggressive tax planning—reveal no statistically significant impact on foreign income across both tariff-affected and exempt subsamples. This finding suggests that while traditional tax avoidance (as proxied by CETR) can influence income allocation, more sophisticated tax planning methods may be reaching their practical or regulatory limits.

5. Discussion

The baseline regression results reveal a statistically significant and economically meaningful relationship between corporate tax avoidance, measured by cash effective tax rate (CETR), and the foreign income ratio of U.S. multinational enterprises. Specifically, a one-unit decrease in CETR leads to a 1.94 percentage point increase in the foreign income ratio, indicating that lower effective tax rates substantially encourage profit shifting and international resource allocation. This finding confirms earlier theoretical propositions by Grubert and Mutti (2000) and Dharmapala (2020), who suggest that tax minimization increases the capacity and incentives for multinational firms to reallocate income abroad under heterogeneous tax regimes.

A crucial contribution of this study is its demonstration of how trade policy shocks, particularly escalation of import tariffs during the U.S.–China trade war, augment the impact of tax avoidance on foreign income allocation. Firms operating in high-tariff exposure sectors show nearly double the tax sensitivity, reflected in a 4% increase in foreign income ratio per unit CETR decrease. Notably, for firms with low or no tariff exposure, tax avoidance exhibits no statistically significant impact on foreign income. This heterogeneity challenges the neutrality assumption underlying the 2017 Tax Cuts and Jobs Act (TCJA). Instead, the findings indicate that the effectiveness of tax incentives is conditional, relying heavily on the external trade environment and the firm's supply chain vulnerability. These results support the contingency perspective in international business and public finance, suggesting that fiscal policy cannot be evaluated in isolation. As recent literature (Chen et al., 2023; Clausing, 2020) argues, tax relief only promotes international competitiveness and operational flexibility when external cost shocks, such as tariffs, are present and when firms have scope for strategic resource realignment.

For low- or no-tariff firms, tax avoidance is statistically insignificant. This contradicts the tax neutrality assumption in the original TCJA framework, supporting Hanlon et al. (2019) and Gale et al. (202), who argue that unexternal frictions overstated the TCJA's redefects. As a proxy for aggressive tax planning, residual book-tax differences (DDBTD) have no strong or consistent relationship with foreign income across all models. Dharmapala (2020) suggests that sophisticated tax arbitrage mechanisms may have reduced marginal effectiveness due to the lack of significance. Though the study also has some limitations, the result still provides some insights into this field.

6. Conclusions and Implications

This study provides new firm-level evidence on how U.S. corporate tax cuts interact with trade protectionism to affect multinational enterprises' foreign income allocation between 2015 and 2019. The main finding is that lower cash effective tax rates (CETR) continue to encourage profit shifting abroad, despite the theoretical expectation that the Tax Cuts and Jobs Act (TCJA) would reduce incentives for foreign income allocation. Importantly, this negative CETR-foreign income relationship is significantly amplified for firms in industries exposed to high import tariffs, suggesting that fiscal benefits serve as liquidity buffers against tariff shocks rather than as drivers of domestic reinvestment.

The research demonstrates that the effectiveness of tax policy is conditional on the trade policy environment. Tax minimization alone does not overcome the disruptions caused by protectionist measures such as tariffs, which induce multinational firms to reinforce their international financial flexibility and supply chain resilience. For firms in sectors with limited tariff exposure, the marginal effect of tax avoidance on foreign income is not statistically significant, highlighting the importance of trade sensitivity in policy design.

These findings emphasize that tax policy, when implemented as a standalone instrument, offers limited power to influence the international allocation of corporate income. The study calls for more integrated public policy frameworks, combining tax reform and trade liberalization, to better support multinational competitiveness during periods of geopolitical uncertainty and global supply chain disruption.

Several limitations should be noted. Although the regression strategy controls for fixed effects and observable firm heterogeneity, potential endogeneity and omitted variable bias may still arise. The sample is limited to U.S. manufacturing firms during 2015–2019; future research should examine whether these patterns persist in other sectors and under evolving trade regimes.

In conclusion, the results suggest that a coordinated approach, aligning fiscal and trade measures, is essential for sustaining U.S. multinational enterprises' international revenue streams and resilience in the face of global shocks.

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