International Tax Reform in a Second Best World: The GILTI Rules

University of Chicago Tax Conference

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The Basics of the GILTI Rules

- U.S. Shareholder of a CFC includes in income as GILTI excess of “net CFC tested income” ("tested income") over “net deemed tangible income return” ("net QBAI Return") for taxable year.

- Net QBAI Return is generally 10 percent of qualified business asset investment ("QBAI") minus interest expense taken into account in computing tested income ("specified interest").

- QBAI is generally tangible asset basis determined under ADS system.

- The GILTI inclusion is generally computed at the shareholder level. Share of losses from a loss CFC can offset income share from an income CFC; QBAI is an aggregation of shares of tangible assets of CFCs determined at shareholder level. However, assets of a loss CFC not taken into account in computing QBAI.
Domestic corporations benefit from a 50 percent deduction (the “GILTI deduction”) against the GILTI inclusion. This deduction is reduced to 37.5 percent for taxable years beginning after December 31, 2025.

There is a special GILTI basket (nonpassive income) for foreign tax credits; only 80 percent of foreign tax credits are creditable; and there is no carryover of foreign tax credits within the GILTI regime.
Key Policy Calls Relating to GILTI

- Overall approach rather than per country approach generally.
- Bifurcated approach: net QBAI return is exempt; remaining GILTI inclusion of domestic corporation subject to taxation albeit at reduced rate.
- No special treatment of round tripping.
- No Section 250 deduction for individuals; thus, unreduced rate.
- No carryovers of at least foreign tax credits.
- Significant reduction in amount of foreign taxes creditable.
- Much of Subpart F left intact.
How does Section 163(j) apply to GILTI?

How are deductions (including interest deductions) allocated for purposes of foreign tax credits?
What We Are Going to Discuss

- The Bifurcated Regime: the distinction between net QBAI return and amounts in excess of net QBAI return.
  - Economic rationale for this aspect of regime.
  - Policy issues with determination of exempt return under statute.
  - The treatment of debt under the regime.
  - Alternative approaches.
- FDII as a Complement to GILTI?
  - Basic policy calls.
  - Policy issues.
  - Statutory fit.
  - Likely impact.
- Core Conceptual Issues Relating to GILTI and Section 163(j).
- Overview of Issues Relating to Allocation of Interest Expense for Foreign Tax Credit Purposes (time permitting).
Policy Background to GILTI:
THE BIFURCATED SYSTEM
Economic Rationale for Bifurcated Regime

- Economic rationale for bifurcated regime with respect to foreign minimum tax provided in *Altshuler and Grubert (2013)*.
- Distinction between “normal” returns and “supernormal” or “inframarginal” returns.
- Elements of return from capital investments: (1) risk free return; (2) risk adjusted return; (3) supernormal return; and (4) inflation adjustment.
- Although some commentators use terms in different manner, we will refer to risk adjusted return (perhaps adjusted for inflation) as “normal return”.
- Inframarginal returns can be associated with patents or other market power.
- General concepts: tax on normal returns affects level of investment and economic efficiency; tax on supernormal return in general does not affect investment level and efficiency.
- Important identity: expensing of equity investment generally equivalent to exemption of normal return.
Two Different Approaches to Distinguishing Normal and Supernormal Returns

- *Altshuler and Grubert* proposed for consideration simply expensing tangible property for Minimum Tax purposes and imposing Minimum Tax of 15 percent. Note that there is to a significant extent expensing with respect to intangible property under current law. *Altshuler and Grubert* on the purpose for the regime: “The expensing under the minimum tax is intended to make the forward looking U.S. effective tax rate (ETR) on the normal return to investment zero while the forward looking ETR on the excess return bears a total tax, including both the foreign and U.S. components, of at least 15 percentage points.”

- The 2017 Tax Act took a different approach to distinguishing types of returns, exempting the 10 percent return on QBAI (after taking into account interest on debt). Similar to Nordic dual income approach, which was also reflected in the House passthrough provisions.
Pervasiveness of These Concepts During 2017 Tax Legislation

- Professor Christopher Hanna:
  As part of the 2017 tax reforms, a tax on supernormal returns was thought to be efficient and desirable. As a result, Congress permitted expensing of certain capital or investments by businesses, thereby taxing only the supernormal return on investments. In addition, Congress substantially changed the U.S. international tax regime imposing no U.S. tax on the normal rate of return from a foreign investment but imposing a tax on the supernormal return.

- As noted House passthrough provisions, which were significantly different than the passthrough provisions ultimately adopted, applied similar concepts.
Relationship to CIN and related concepts. *Altshuler and Grubert*:

Taxing the excess return would not put U.S. companies at a competitive disadvantage in making foreign investments and acquisitions. They will still make the investments if they are more efficient than their rivals. If the intangible that is the source of the excess return is mobile, such as a patent used to produce a good sold on the worldwide market, the tax may just change where the investment is made.

Note, though, that everything else being equal the minimum tax might affect where a group would want to be resident for tax purposes.

GILTI rules, in effect, balance different policies.
Moreover, those who tend to emphasize CEN would view the net QBAI return exemption as a problem. Under their particular assumptions, Altshuler and Grubert did not think there would be an increased “runaway plant” problem:

There may be some concern that allowing expensing against the minimum tax on foreign income, but not on domestic income, will result in runaway plants. The simulations show that this result is unwarranted. Even with expensing the minimum tax results in a much higher effective tax rate in the low-tax country than under current law.

Note that the U.S. will have expensing domestically over the short run, which was not an assumption of Altshuler and Grubert.
The GILTI Regime and Roundtripping

- Roundtripping is the location of assets (including intellectual property) in CFC of U.S. parented group and sale of product back into the U.S.
- Should roundtripping benefit from favorable treatment of net QBAI return? Should Section 250 GILTI deduction apply?
- Although the draft Camp legislation discriminated against roundtripping income, the 2017 legislation did not.
- The decision not to treat roundtripping specially in the statute can be viewed as consistent with CON principles.
- Other approaches to roundtripping were discussed informally in 2017.
- Is the real issue the treatment of inbound business?
- One result of treatment of roundtripping is that FDII rules cannot be viewed as achieving full neutrality with all business activities covered by GILTI regime; FDII rules only cover activities with a non-U.S. destination.
The Determination of Net QBAI Return
Distinction Between Normal and Inframarginal Returns: Subtle (Slippery?) Concepts

- Must be careful to distinguish relatively high risky returns that were assumed to be low probability *ex ante* from true inframarginal returns.
- Normal return from an investment should be measured over life of investment.
- Much of the 2017 tax legislation does not really reflect fully the full application of the core economic concepts: e.g. treatment of losses and loss carryovers.
- Do we really think that we can tax inframarginal returns heavily without impairing economic efficiency? There is a good reason we grant patent rights.
The statutory rate is fixed at 10 percent.

Risk adjusted equity or debt rates: which are more appropriate?

The appropriate rate can depend on various aspects of the overall regime.
  - Does the rate vary with inflation and/or current interest rates?
  - Treatment of losses and carryovers under the relevant law.
  - Is there a carryover of the excess QBAI net return?
  - Is the base fixed or does it depreciate?

Compare the House-side rate: short-term interest rate plus 7 percent.

Query whether this is really a serious issue.
Statute takes into account only tangible assets.

Is there discrimination against types of industries, for example banks?

Does expensing under current law compensate for lack of QBAI in certain industries?
- There may have been expensing with respect to customer-based intangibles and assets such as processes.
- But financial equity capital may not be taken into account fully in the system.

Why should purchased intangibles not be included in base?

Should there be a deemed step up after stock acquisitions?

Is there neutrality of treatment of purchased and leased assets?
Net QBAI Return: The Treatment of Debt

- The design decision was ultimately made that there must be adjustment for debt financing of assets. This adjustment was not contained in original Camp draft statutory language or in Senate bill.
- There are basically two different possible approaches.
  - Net liabilities against basis; thus, base would be net basis.
  - Subtract interest from the deemed return on assets.
  - The subtract interest approach was adopted.
- Three characteristics of statutory approach.
  - Because subtract interest approach is used, taxpayer benefits by difference between interest rate on debt and statutorily deemed equity return.
  - Interest of CFC is in effect stacked against OBAI; specified interest is all interest relating to tested income.
  - Interest is deducted even with respect to loss CFC the assets of which do not contribute to OBAI.
A significant planning (and policy) issue may be the location of debt.

For example, in the case of a CFC with significant QBAI, the statute may induce taxpayers to borrow at U.S. Shareholder level and contribute to equity of a CFC rather than borrow at CFC level.

Will planning actually be affected by this aspect of the GILTI rules?

Does this type of possible planning call into question the viability of the statute?

Does it affect significantly the extent to which post-tax reform debt will be incurred at U.S. parent level?

Will the recently proposed Section 956 regulations facilitate this type of planning? Prop. Reg. Sec. 1.956-1(a)(2).
The proposed GILTI regulations take an expansive view of interest expense under Prop. Reg. 1.951A-4(b)(ii):

The term interest expense means any expense or loss that is treated as interest expense by reason of the Internal Revenue Code or the regulations thereunder, and any other expense or expense or loss incurred in a transaction or series of integrated or related transactions in which the use of funds is secured for a period of time if such expense or loss is predominantly incurred in consideration of the time value of money.

Note that the statute does not have any explicit treatment of amounts equivalent to interest. Compare Section 954(c)(1)(E) relating to “income equivalent to interest”.

The regulation authority contained in Section 951A(d)(4) appears to relate solely to QBAI.

However, unlike the legislative history with respect to Section 163(j), the legislative history does not appear to limit specified interest to an amount “treated as interest for purposes of the Internal Revenue Code.”
Under the proposed GILTI regulations, it appears that there may be an advantage to financing CFCs with straight preferred stock rather than debt.

Preferred Stock Illustrative Case:
CFC has two classes of stock, 70 shares of common owned by USP and 30 shares of 4% nonparticipating preferred stock, par value $10x per share, owned by FP. Assume CFC has $120x of test income and $750x of QBAI. Under the regulations, USP’s share of the tested income would be $108x ($120x – $12x). The 12x is FP’s share of tested income is (.04 * 10x * 30) with respect to the preferred. USP’s share of the QBAI would be $675x ($750 * 108x / $120x). USP would thus have 10 * 675x of net QBAI return, or $67.5x.

Analogous Debt Illustrative Case:
Assume instead of preferred stock, debt issued with same terms. Tested income allocable to USP (now sole shareholder) would be $108x again ($120x – $12x). USP’s share of QBAI would be $750x because there is no other shareholder. The net QBAI return would be $75x – $12x = $63x, significantly less than in the preferred case.
Under Section 951A(b)(2)(B), the interest paid by CFC1 to CFC2 is generally not treated as specified interest that reduces net QBAI return if the attributable interest is taken into account by USP. Reg. Sec. 1.951A-1(c)(3)(iii).

The proposed GILTI regulations treat inclusions from interest from third-parties as attributable interest taken into account by USP.

As a conceptual matter why should same treatment not apply to loan by USP to CFC2?
**Net QBAI Return: The Treatment of Carryovers**

- A notable aspect of the GILTI regime is its stark year by year approach.
- In this regard, it is notable there is no carryover of excess (unused) net QBAI return. This aspect of the bifurcated regime may affect how we think of the level of the rate.
- Although it is clear from the statute that excess net QBAI return cannot be carried over, it appears that Treasury and the Internal Revenue Service would have the ability to provide for the carryover of actual net operating losses, consistent with Section 954(b)(5) principles.
A notable aspect of the GILTI statutory regime, at least as interpreted by the legislative history and proposed GILTI regulations, is the treatment of the assets of loss CFCs.

Prop. GILTI Regulations provide “None of the tangible property of a tested loss CFC is specified tangible property.” Prop. Reg. Sec. 1.951A–3(c)(1).

This rule is consistent with language in the legislative history.

Given the general overall approach of the statute, the policy basis for this rule is unclear.

The notch effect is obvious; one dollar of loss can have a major impact.

Check the box and other planning are likely to be induced.

In any case, the distortions of this rule do not go to the basic approach exemplified in the GILTI rules and could be corrected by subsequent legislation.
The myriad issues with the computation of net QBAI return raise the question whether a completely different approach is justified.

One possibility would be to go to complete expensing approach with no deduction for interest solely for computing GILTI.

Ryan-Brady for GILTI!

Issues similar to those discussed with respect to Ryan-Brady arise.

- Treatment of large losses generated by expensing.
- Difficult to remove all nonneutralities. Leasing versus buying nonneutrality, e.g.
- Still strong incentive to find financing equivalents that are not treated as interest, particularly when only part of expense is equivalent to interest.
As the policy debate with respect to the bifurcated regime of GILTI continues, one major question is how important is all this to the overall working of the international corporate tax regime?

The exemption for net QBAI return has its most significant effect with respect to business activities in low or no tax jurisdictions.

In other cases, the treatment of foreign tax credits dominates.
Sullivan on GILTI
**GILTI: Marginal Tax Rate on Foreign Investment**

<table>
<thead>
<tr>
<th></th>
<th>Invest in Low-tax Country</th>
<th>Invest in High-tax Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Limit Corp.</td>
<td>[see model]</td>
<td>((1-F%)t_H + t_{US}(1-G%))</td>
</tr>
<tr>
<td>(ww foreign rate &lt; (t^*))</td>
<td></td>
<td></td>
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<tr>
<td>Excess Credit Corp.</td>
<td>(t_L)</td>
<td>(t_H)</td>
</tr>
<tr>
<td>(ww foreign rate &gt; (t^*))</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[ t^* = (1-G\%)t_{US}/F\% \]

Current law: \(G\%=0.5\), \(F\%=0.8\), \(t_{US}=0.21\)

So, \(t^* = 13.125\%\)

If \(G\% = 0.75\), then \(t^* = 6.56\%\)

**Cross-crediting**

**Pure territorial**

**Example: Current Law**

<table>
<thead>
<tr>
<th></th>
<th>Invest in Country with 5% Rate</th>
<th>Invest in Country With 30% Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Excess Limit Corp.</td>
<td>[could be 11.5%]</td>
<td>(0.2)(30%) +(10.5%) 16.5%</td>
</tr>
<tr>
<td>(ww foreign rate &lt; (t^*))</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excess Credit Corp.</td>
<td>5%</td>
<td>30%</td>
</tr>
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<td>(ww foreign rate &gt; (t^*))</td>
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**Increasing section 250 deduction (G\%) makes system more territorial, average foreign rate that triggers min tax treatment low, fewer firms subject to min tax.**
**Model.** Base Case policy parameters (current law): \( T_{us} = 21\% \). \( G\% = 50\% \). \( Q\% = 10\% \) \( F\% = 80\% \) Base Case assumptions: US tangible capital = $100. US intangible = $100. F tangible = $100. F intangible = $100. Return = 16\%. \( T_f = 5\% \). **No profit shifting.**

**Tax Rates on Foreign Investment**

<table>
<thead>
<tr>
<th>From To</th>
<th>Marginal Tax Rate</th>
<th>Average Tax Rate</th>
<th>From To</th>
<th>Marginal Tax Rate</th>
<th>Average Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Prior Law&quot;</td>
<td>5.0%</td>
<td>5.0%</td>
<td>&quot;Prior Law&quot;</td>
<td>5.0%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Base Case</td>
<td>- -</td>
<td>4.9%</td>
<td>8.2%</td>
<td>Base Case</td>
<td>- -</td>
</tr>
<tr>
<td>( G% = )</td>
<td>50%</td>
<td>75%</td>
<td>3.0%</td>
<td>4.6%</td>
<td>( G% = )</td>
</tr>
<tr>
<td>( Q% = )</td>
<td>10%</td>
<td>15%</td>
<td>1.7%</td>
<td>6.6%</td>
<td>( Q% = )</td>
</tr>
<tr>
<td>( F% = )</td>
<td>80%</td>
<td>100%</td>
<td>4.0%</td>
<td>7.3%</td>
<td>( F% = )</td>
</tr>
<tr>
<td>( TUS% = )</td>
<td>21%</td>
<td>17%</td>
<td>4.2%</td>
<td>6.8%</td>
<td>( TUS% = )</td>
</tr>
</tbody>
</table>

**POLICY PARAMETERS:**
- **Increase** \( G\% \) (the section 250%), increase territoriality, reduce min tax
- **Increase** \( Q\% \) (the QBAI return), reduce excess profit, reduce min tax
- **Increase** \( F\% \) (creditability of F tax), increase FTCs, reduce min tax

**TAXPAYER CHARACTERISTICS:**
- Smaller portion of profits from **foreign intangibles**, lower average tax rate
- **Low-profit investment**, excess profit negative, incentive for foreign capital
- **More profit shifting**, lower marginal tax rate, incentive for foreign capital

**Tax Rates on Foreign Investment**

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<tr>
<td>Base Case</td>
<td></td>
<td>-4.6%</td>
<td>3.5%</td>
<td>Base Case</td>
<td></td>
<td>-4.6%</td>
<td>3.5%</td>
</tr>
<tr>
<td>$G% = 50%$</td>
<td>$75%$</td>
<td>-11.8%</td>
<td>-2.8%</td>
<td>$KFI = $100</td>
<td>$0$</td>
<td>4.9%</td>
<td>4.9%</td>
</tr>
<tr>
<td>$Q% = 10%$</td>
<td>$15%$</td>
<td>-7.8%</td>
<td>1.8%</td>
<td>$R% = 16%$</td>
<td>$5%$</td>
<td>-19.0%</td>
<td>-3.8%</td>
</tr>
<tr>
<td>$F% = 80%$</td>
<td>$100%$</td>
<td>-6.5%</td>
<td>2.0%</td>
<td>$TF = 5%$</td>
<td>$0%$</td>
<td>-6.6%</td>
<td>2.0%</td>
</tr>
<tr>
<td>$TUS% = 21%$</td>
<td>$17%$</td>
<td>-3.3%</td>
<td>3.1%</td>
<td>$S = 1$</td>
<td>$1$</td>
<td>-4.6%</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

**COMMENTS:**
- More realistic than no-shifting case. About half the profit shifting assumed by Grubert and Altshuler.
- Profit shifting central role in incentive effects (not just revenue effects).
- Marginal tax rate on Investment with low profitability particularly troubling. This is cause for press reports like *NYT* (Jan. 8) “Tax Law May Send Factories and Jobs Abroad, Critics Say”
- Is there some revenue-neutral set of values for $(Q\%, G\%, F\%)$ that promote better policy
- Can case be made incentives for foreign investment still too large? Are inversions still a threat?
Notes on Model (for reference)

**Base Case.** Current law (Tus = 21%, G% = 5%, Q% = 10%, F% = 8%) and foreign tax rate of 5%. U.S. parent corporation has $100 of tangible capital and $100 of intangible capital that all earns 16 percent. Its CFC has the same amounts of capital and rate of return. So $32 of domestic profit and $32 of foreign profit. No profit shifting. Under a pure territorial system multinational pays 21% times $32 = $6.72 of U.S. tax and 5% times $32 = $1.60 of foreign tax. With GILTI, "normal" profit of CFC is 10% times $100 (of tangible capital) = $10. Excess profit is the product (1-G% = 50%) times ($32 minus $10 = $22) equals $11. GILTI tax (before FTCs) is 21% times $11 = $2.31. With F% = 80%, only (80% of $1.60 = $1.28) is creditable. Net yield of GILTI after FTC is ($2.32 - 1.28 = $1.04). Total U.S tax is $6.92. Total tax of foreign income is the sum of $1.60 (foreign) and $1.03 (U.S. GILTI) which equals $2.63. On $32 of income that is an average tax rate of 8.2%.

**Marginal investment.** If $100 investment in foreign tangible capital increases by $100, foreign income increases by $16.00 (to $48.00) and foreign tax increase by $0.80 ($2.40). "Normal" profit increases to $20 (=10%*$200). Excess profit is the product of $28 (=48-$20) times 50% (=1-G%) which equals $14. GILTI tax (before FTCs) is 21% times $14 = $2.94. With F% = 80%, only (80% of $2.40 = $1.92) is creditable. Net yield of GILTI after FTC is $1.02 ($2.94 - 1.92). Total tax of foreign income is the sum of $2.40 (foreign) and $1.02 (U.S. GILTI) which equals $3.42. Tax increase from marginal investment is $1.59, the GILTI increase of $0.79 (= $3.42 - 2.63) and foreign tax increase of $0.80 (= $2.40 - $1.60) on an increase in foreign income of $16.

**Shift Function** (S) is the dollar amount of profit shifted out of the United States. It is a positive linear function of a constant (s), foreign tangible capital (KFT), and the return on capital (R). If s equal to 1 then each $100 of tangible capital invested outside the United States induces a shift in foreign profit by $16. This shift reduces U.S. regular tax on domestic profits by $3.36 (= 0.21 x $16), increases foreign taxes by $0.80 (= 0.05 x 16). The tax effect of GILTI is $1.68 (=(1-G%)*TUS*$16 = 10.5% of $16) offset by $0.64 (=(1-FTC%)*TF*$16) of foreign tax credit. The total tax change from the $16 shift in profit is a reduction in tax of $1.52. So $100 of additional foreign investment results in this amount (-$1.52) plus a slight reduction in GILTI (-$0.01) plus an increase in regular tax of $0.80. Net of negative $0.73 on a $16 increase in income yields a marginal tax rate on foreign investment of negative 4.6%.
How and Why Should Some Foreign Profits Be Subject to Minimum Tax?

**Investment with “excess” profit** (think monopoly) is insulated from competition. Provide relief only for “normal” returns. (Grubert-Altshuler) In other words, CIN for investment that needs it. CEN for those that can afford it.

- Expensing achieves this. (In practice would be lower rate of return than 10% of QBAI. But can easily adjust upward if method was considered simpler.)

- Interesting that G-A approach not specifically designed to target intangibles of profit shifting

**Shift intangibles back to United States.** (legislative history). How does this help U.S. job creation? Overshoots on profit shifting when there are foreign-developed (marketing) intangibles.

**Prevent profit shifting.** Necessary backstop to arm’s-length pricing under increased pressure from territorial system. Consider alternatives to QBAI such as conventional (industry-specific) transfer pricing profit level indicators as base amounts in determination of excess profits.

**Provide incentive for certain investment** complementary to U.S. investment that helps create rather than substitute for U.S. jobs. See Desai, Foley and Hines (2005) on complementary investment. (For example, allow extra deduction for foreign marketing, customizing, advertising.)

**No relief for “normal” profits.** Consider taxing all (non Subpart F) profits equally. Rough estimates indicate this would allow revenue-neutral cut in GILTI effective rate from 10.5% to about 8.5%.
FDII as a Complement to GILTI: Policy Background
In terms of the distinction between normal and supernormal returns, the FDII rules can be seen as attempting to treat supernormal returns from U.S.-based international business in a way roughly equivalent to the treatment of supernormal returns under GILTI: only amounts above a return on QBAI qualify.

The FDII rules are not intended to apply to roundtripping. As noted, however, the FDII rules are not really responsive to the incentives for round-tripping as to U.S. market.

The FDII rules can be viewed as one part of the attempt to move toward greater neutrality in the tax treatment of international business location, rather than as an export subsidy per se.

However, as with the case of an explicit export subsidy, it is fair to discuss the actual incentive effect of the statute and whether the distinction between winners and losers is rational.
A threshold question is whether the policy decision made to address only the supernormal returns was the correct one.

After GILTI there is a tax advantage for CFC-based international business operations with respect to both normal returns on tangible assets and supernormal returns on intangibles.

Even if treatment of net QBAI return under GILTI does not lead to true “runaway plant” issue, does treatment of QBAI under FDII complicate the question?

Altshuler at Brookings conference:
“So, it’s kind of a perverse incentive . . . you have the incentive to put tangible assets that are earning less than 10 percent abroad under GILTI, and you also have the incentive under FDII.”

Actually to exempt normal return and cut rates on supernormal returns would seem a bit extreme when we are not significantly taxing inbound business either.

FDII may really be understood as a response to patent box regimes.
FDII: The Location of Intangible Rationale

- Senate Budget Committee Report:
  “The Committee believes that offering similar preferential rates for intangible income derived from serving foreign markets, whether U.S.-based operations or through CFCs, reduces or eliminates the tax incentive to locate or move intangible income abroad, thereby limiting one margin where the Code distorts business investment decisions.”

- Why do we care about the location of intangibles if we can tax the income therefrom?

- Turning the previously discussed economic concepts on their head. The Mirlees Review on the basis for taxing mobile returns at a lower rate (under a patent box) than less mobile returns:
  This would allow a higher rate of corporation tax to be supported on less mobile (location-specific) economic profits, while using a lower rate to reduce the deterrence to mobile income…[S]een in this light, patent boxes may allow governments to maintain a higher tax rate and therefore collect more revenue from other, less mobile, forms of corporate income than would otherwise be the case.
FDII: The Basic Calculation

FDII = DII * FDDEI/DEI; FDII = (DEI-10%*QBAI)*FDDEI/DEI

- Section 250(a)(1)(A) of the Code provides a new deduction to U.S. corporate taxpayers equal to 37.5% of their “foreign-derived tangible income.”
  - The amount of the deduction is reduced to 21.875% in taxable years beginning after December 31, 2025.
- FDII equals the U.S. corporation’s “deemed intangible income” (DII) multiplied by a ratio.
  - The ratio equals the proportion of the corporation’s net deduction-eligible income (DEI) income that is derived from (a) property sold or leased to non-U.S. persons for a foreign use, or (b) services provided to any person or property located outside of the United States (i.e. FDDEI)
    - Property sold to a related foreign person can only count for these purposes if that related person sells, or uses that property in connection with the provision of services or the sale of other property, in each case to an unrelated non-U.S. person.
    - The calculation of DEI and FDDEI is determined by taking into account deductions attributable to such net income, and without regard to its Subpart F income, GILTI income, dividends from CFCs, and certain other items.
    - By virtue of this rule, deductions attributable to DEI would effectively give the U.S. corporate taxpayer a reduced tax benefit compared to deductions that are allocable to non-DEI. The reason is because the FDII-related deductions only reduce income that is taxed at a lower FDII rate.
- DII is an amount equal to (x) DEI minus (y) a deemed 10% return on the company’s basis in tangible depreciable property used in a trade or business (QBAI). The identification of tangible depreciable property for these purposes is based on the similar rules for FILTI income, except that interest expense does not reduce QBAI for FDII.
Maximizing FDII Deduction

FDII = (DEI-10%*QBAI)*FDDEI/DEI

- Based on this formula, FDII deduction-eligible income can be influenced in three distinct ways:
  - Reduce QBAI: For example, equipment leasing.
  - Increase FDDEI: The higher the foreign-derived deduction eligible income, the higher the ratio for FDII.
  - Increase DEI: FDII deductions actually increase just by increasing general deduction-eligible income, regardless of whether or not it is foreign.
The Critique of FDII: Sullivan
A deduction for excess U.S. profit ("intangible") and U.S. export ("foreign derived") income.

- Under “strategic trade theory” export subsidy might be O.K. for certain industries under certain circumstances. Not sure “disease” exists and only by chance would FDII be the “cure.”
- In context of export subsidization “round-tripping” is an abuse. FDII does not share VAT features that prevent this. Treasury left with no choice but to write burdensome or ineffective regulations. Neutrality will be elusive.
Sullivan on FDII (cont.)

- Don’t need export component to attract intangible profits back to the United States. (No corresponding “foreign-derived” requirement in GILTI.)
- Larger benefit for vertically integrated exporter (not fixable). In response, business restructure internally and with each other.
- Benefit not available to Sub S, partnerships, individuals (fixable).
- Loophole? Sales by foreign branches not satisfying requirements of QBU considered “foreign-derived”?
Conventional economic framework tells us to TAX excess profits. If anything, we should tax excess profit at higher rate. FDII does the opposite.

FDII is a poor subsidy for externality-generated domestic research. Like rate cut, windfall to prior investments. Not precisely targeted to intangibles. And intangible income benefit not all from research.

QBAI mechanism can actually discourage domestic investment if rate of return is less than 10 percent.

There seems to be no discernable positive effect on U.S. job creation or U.S. labor productivity from relocation of ownership of intangible assets to the United States.

Compare to rate cut or extra research incentive as alternative.
Jonathan Brenner and Josiah Child have described respect in which there would be GILTI if business conducted in CFC, but not FDII if business conducted in U.S. The issue appears to be the treatment of debt.

Example of application of GILTI:
Assume first a CFC wholly owned by USP, which only owns CFC. CFC has 100 of QBAI, pre-interest tested income of 20 from foreign sales and 10 of interest deductions. Because the interest expense reduces the net QBAI return to zero, USP would have a 10 GILTI inclusion under these facts.

Assume same basic facts, except the business is based in the U.S. with only sales abroad: same QBAI; same interest expense; same pre-interest tested income. USP will have deduction-eligible income of 10 (20-10). Because this amount does not exceed 10 percent of the 100 QBAI, there would be no deemed intangible income and thus no FDII.
FDII: What Will Be The Effect of FDII?

- Will FDII actually affect location decision?
- Is FDII regime competitive with patent box regimes?
- How much effect is the international legal uncertainty?
Section 163(j) Policy Background
Section 163(j): Policy Background

- Section 163(j) could be described as taking a debt-equity approach to restrictions on interest deductions because 30 percent limitation is based on amount of adjusted taxable income ("ATI") (generally EBITDA for years beginning before January 1, 2022; generally EBIT thereafter). N.B., however, tax exempt interest does not count as ATI although available to service debt.

- Although it was clear under the Framework that there was going to be a major limitation on interest deduction domestically, two other policy choices were made that affect the overall impact.
  - First, decision was made to apply the limit at the level of partnerships and other unincorporate businesses. Some restriction on interest deductibility was inevitable with full expensing; the method of the application to partnerships is debatable.
  - Second, the restriction was applied as a specific limit, not a proportional disallowance of interest, which was favored by some in government. The result is a "notch" effect.

- There appears to have been very little discussion during the legislative process of how Section 163(j) would apply internationally.
No comprehensive anti-arbitrage apportionment of interest to GILTI income was enacted. Compare Obama administration proposals:

Under [the] proposal, a taxpayer must allocate and apportion interest expense among foreign source gross income subject to tax at the full U.S. statutory rate, foreign source gross income subject to various rates under the minimum tax and foreign source gross income on which no foreign tax is imposed. Interest income allocable and apportioned to foreign source gross subject to the minimum tax would be deductible only at the minimum tax rate, while no deduction would be permitted for interest deductions, allocated and apportioned to income on which no U.S. tax is imposed.

Moreover, proposed Section 163(n), which would have disallowed the interest deduction with respect to disproportionate U.S. leverage, was not adopted.

The BEAT does address base erosion for interest that reduces U.S. tax base.

Section 864(e) amended to repeal fair market value method of apportionment.

But provisions adopted do not really directly address interest related to GILTI.
Section 163(j) and GILTI: The Passthrough and Consolidated Return Analogies
Section 163(j) and GILTI: Will A Passthrough Approach Apply?

- Section 163(j)(4) comprehensively addresses the application of Section 163(j) to partnerships.
- Although there are a significant number of technical issues with the statute, the statute appears to have two basic objectives:
  - To limit the use of carried over excess interest deductions allocated to partners to the partnership’s excess limitation allocable to partners (“ETI”).
  - To prevent double counting of the same adjusted taxable income at the level of both the partnership and the partners.
- Should the double counting concept apply in GILTI (and Subpart F) context?
Section 163(j) and GILTI: Effect of GILTI Inclusion on ATI

Generally

- How much should USP’s ATI be increased by GILTI inclusion?
- Straightforward reading would be 100-50=50.
- Is this justified as a policy matter? Note difference if CFC a branch.
- Perhaps this treatment is justified because U.S. tax effect of deductions is less.

Diagram:

- USP
- BANK
- CFC

100% loan
interest

No borrowing
GILTI of 100
Section 163(j) and GILTI: Effect of GILTI Inclusion on ATI

Generally

- Assume a case that CFC has interest deductions exactly equal to 30 percent of ATI. Should the net GILTI inclusion (after subtracting the GILTI deduction) increase USP’s ATI?
- Will the government limit this species of double counting?
- Note in this regard that Section 163(j)(8)(B) provides that adjusted taxable income shall be “computed with such other adjustments as provided by the Secretary.”
- Another reason to use preferred stock if double counting prohibited?
Should the interest payable by CFC2 to CFC1 be subject to limitation under Section 163(j) if it is fully includible to CFC1? Compare Section 951A(b)(2)(B). How should third-party interest income of CFC1 enter into the equation?

- Should the inter-CFC debt just be ignored? See Notice 2018-28 re interest on debt between members of a consolidated group.
- Should loan from USP to CFC2 be treated consistently with loan from CFC1 to CFC2?
Worldwide Application of Section 163(j): Spinowitz
Example 1 Assumptions:
- CFC Tested Income (Pre-IE) = 100x
- CFC Interest Expense = 40x
- No Local Country IE Limitation
- Foreign Tax Rate = 20%
- Foreign Tax = 12x (20% * (100x - 40x))

Results without Application of 163(j)
- GILTI (+ s.78 gross-up) = 60x (100x - 40x -/+ 12x)
- FTCs = 9.6 (80% * 12x)
- U.S. Tax Pre-FTCs = 6.3 (60 * 50% * 21%)
- U.S. Residual Tax = 0
- WW Tax = 12
- WW ETR = 20% (12/60)

Results with Application of 163(j)
- GILTI (+ s.78 gross-up) = 70x (100x - 30x)
- FTCs = 9.6 (80% * 12x)
- U.S. Tax Pre-FTCs = 7.35 (70 * 50% * 21%)
- U.S. Residual Tax = 0
- WW Tax = 12
- WW ETR = 20% (12/60)
Example 2 Assumptions:
• CFC Tested Income (Pre-IE) = 100x
• CFC Interest Expense = 40x
• No Local Country IE Limitation
• Foreign Tax Rate = 13.125%
• Foreign Tax = 7.875x (13.125% * (100x - 40x))

Results without Application of 163(j)
• GILTI (+ s.78 gross-up) = 60x (100x - 40x -/- 7.875x)
• FTCs = 6.3 (80% * 7.875x)
• U.S. Tax Pre-FTCs = 6.3 (60 * 50% * 21%)
• U.S. Residual Tax = 0
• WW Tax = 7.875
• WW ETR = 13.125% (7.875/60)

Results with Application of 163(j)
• GILTI (+ s.78 gross-up) = 70x (100x - 30x -/- 7.875x)
• FTCs = 6.3 (80% * 7.875x)
• U.S. Tax Pre-FTCs = 7.35 (70 * 50% * 21%)
• U.S. Residual Tax = 1.05 (7.35 - 6.3)
• WW Tax = 8.925
• WW ETR = 14.88% (8.925/60)
Example 3 Assumptions:
- CFC Tested Income (Pre-IE) = 100x
- CFC Interest Expense = 30x
- No Local Country IE Limitation
- Foreign Tax Rate = 13.125%
- Foreign Tax = 9.1875x (13.125% * (100x - 30x))

Results (with/without Application of 163(j))
- GILTI (+ s.78 gross-up) = 70x (100x – 30x)
- FTCs = 7.35 (80% * 9.1875x)
- U.S. Tax Pre-FTCs = 7.35 (70 * 50% * 21%)
- U.S. Residual Tax = 0
- WW Tax = 9.1875
- WW ETR = 13.125
Example 4 Assumptions:
- CFC Tested Income (Pre-IE) = 100x
- CFC Interest Expense = 40x
- Local Country IE Limitation = 30x
- Foreign Tax Rate = 13.125%
- Foreign Tax = 9.1875x (13.125% * (100x - 30x))

Results without Application of 163(j)
- GILTI (+ s.78 gross-up) = 60x (100x - 40x +/- 9.1875x)
- FTCs = 7.35 (80% * 9.1875x)
- U.S. Tax Pre-FTCs = 6.3 (60 * 50% * 21%)
- U.S. Residual Tax = 0
- WW Tax = 9.1875
- WW ETR = 15.31%

Results with Application of 163(j)
- GILTI (+ s.78 gross-up) = 60x (100x - 40x +/- 9.1875x)
- FTCs = 7.35 (80% * 9.1875x)
- U.S. Tax Pre-FTCs = 7.35 (70 * 50% * 21%)
- U.S. Residual Tax = 0
- WW Tax = 9.1875
- WW ETR = 15.31%
Worldwide Application of Section 163(j) – Observations

- At higher levels of local tax, the application of 163(j) at the CFC level does not “bite,” as “excess credits” from the smaller local-country tax base are sufficient to offset residual U.S. tax on the larger U.S. tax base. See Example 1.

- At lower (non-zero) local rates, where 163(j) does bite, there is still an incentive to lever the CFC beyond the 163(j) limit to the extent the interest is deductible locally. Compare Examples 2 and 3.

- Reducing leverage in “compliance” with 163(j) would result in increased local tax but NOT increased U.S. tax. Compare Example 2 and 3.
Worldwide Application of Section 163(j) – Policy Considerations

- If GILTI is an economic measure of “excess returns,” what is the rationale for disregarding the return to “excess” debt where a comparable return to equity would not have yielded additional GILTI?
  - Consider consequences at CFC-level if third-party “excess leverage” were instead a preferred equity investment – i.e., reduced pro rata share of GILTI allocable to USP.
  - Consider consequences at CFC-level if “excess leverage” held by USP were instead a preferred equity investment – i.e., additional GILTI would replace the interest income otherwise included by USP and the return on the preferred investment itself generally would be exempt (PTI or 245A eligible). Note tax rate difference at USP level on additional GILTI vs. interest income.
  - Consider consequences at CFC-level if “excess leverage” held by another CFC – i.e., interest income includible in income of creditor CFC and thereby in USP’s GILTI.
  - In latter two cases need to consider treatment of related-party interest income for purposes of measuring the related-party creditor’s 163(j) limitation – treatment as interest income? treatment as business income? disregarded?
- Should disallowed interest be thought of as other types of disallowed deductions or base mismatches (e.g., meals and entertainment)?
GILTI and Foreign Tax Credits: The Allocation of Interest Expenses
New basket created under Section 904(d)(1)(A) for amounts included in gross income under Section 951A (other than passive category income).

Section 904(c) states that carryover and carryback rules do not apply to taxes described in Section 904(d)(1)(A).

There is no special rule contained in the 2017 legislation relating to allocation of interest and other expenses relating to GILTI.

However, Section 864(e) was amended to prohibit allocation of interest expense on the basis of the fair market value of assets.

The proposed Senate legislation to accelerate the election to allocate interest on a worldwide basis to years beginning after December 31, 2017 (rather than years beginning after December 31, 2020) was not enacted.
GILTI and Foreign Tax Credit Limitation: A Simple (Simplistic Approach)

- Assume USP owns all the stock of CFC. USP’s pre-interest income from domestic sources is 100; CFC’s pre-interest foreign income (after gross up) is 100. All CFC’s income is GILTI. USP has 20 of interest deductions, 10 of which are allocated and apportioned to the CFC income.

- A simple way to think of the Section 904 fraction is as follows:

\[
\frac{(100-50-10)}{(100-10) + (100-50-10)} = \frac{4}{13}
\]

- Is that correct conceptually?
GILTI and Foreign Tax Credit Limitation: Basic Conceptual Issues

- First conceptual issue: how should foreign tax credit limitation be adjusted to account for fact that foreign income subject to GILTI is in effect subject to multiple tax rates.
  - This is not a new enterprise. See Section 904(b)(2).
  - Another way to think of GILTI income to which Section 250 deduction applies is as partially exempt.

- The second conceptual issue: how to account for the allocation of expenses (including interest) to this lower taxed income.
  - Neither the statute nor legislative history really address this issue.
  - Moreover, the remnants of longstanding law, the Section 861 Regulations, may actually confuse the issue.
  - The result may be imposition of dubious interest allocation policy through foreign tax credit rules.
If all that is at stake is lower rate of taxation on GILTI income, the appropriate adjustment to Section 904 limitation is straightforward.

Example: USP owns all of stock of CFC. USP has 100 of domestic source income. CFC has 100 of GILTI income subject to foreign taxes of 20; no net QBAI income. After gross-up, GILTI income is 100. If domestic income is subject to 21 percent rate, and CFC income to 10.5 percent rate, the Section 904 fraction should be:

\[
\frac{.5 \times 100}{100 + .5 \times 100} = \frac{1}{3}
\]

The amount of U.S. taxes payable on 100 of CFC’s income is 10.5. The total tax paid by USP is 21 + 10.5 = 31.5.

A credit of 1/3 of 31.5 or 10.5 gives the right result. This is the incremental amount of U.S. tax payable due to the foreign income.
A threshold difficulty, pending issuance of proposed regulations by the Treasury and IRS, is that as a substantive matter, it appears USP gets domestic interest deduction against income subject to 21 percent tax. But depending on the decisions of the Treasury and Internal Revenue Service, interest would still be allocated to the GILTI inclusion for Section 904 limitation. This dichotomy confuses things conceptually.

To see the importance of the interaction between the substantive tax treatment of interest deductibility, it is interesting to compare three cases in which different substantive interest deduction rules are applied, but the principle for allocating interest to foreign income is the same, i.e., the same concepts are used for determining the allocation of interest to foreign income.
Example: USP earns 100 (before U.S. interest) of U.S. domestic source income and 100 of foreign source GILTI (before U.S. interest through CFC (after gross-up)). U.S. tax rate applicable to U.S. income is 21 percent; rate applicable to CFC’s income is 10.5 percent. USP has 20 of interest deductions, 10 of which are deemed allocable to 100 of GILTI inclusion. There are 20 of foreign tax credits at issue (after any other limitation).

First Case: Under the relevant substantive deductibility rule, the 10 allocable to CFC must be deducted against the 10.5 percent taxed income. In that case, the relevant preliminary (before credit) tax would be 

\[0.21 \times (100 - 10) + 0.105 \times (100 - 10) = 28.35.\]

The incremental tax on the foreign source income is \(0.105 \times (100 - 10) = 9.45.\) A Section 904 limitation fraction that yields this result would be:

\[\frac{0.5 \times (100 - 10)}{[(100 - 10) - 0.5 \times (100 - 10)]] = 1/3.\]

\[1/3 \times 28.35 = 9.45.\] The total U.S. tax after credit would be 28.35 - 9.45 = 18.90

This seems to be a reasonable result if you accept the basic deductibility rule.
GILTI and Foreign Tax Credit Limitation: Disallowance for Deductibility and No Apportionment for Foreign Limitation

- Second Case: Under the relevant substantive deductibility rule, we actually disallow the deductibility of the 10 deemed allocable to the GILTI income. This substantive rule is broadly analogous to the type of rule that would be applied if Section 163(n) were applied; in other words, none of the amount in question is apportioned to the low taxed income. In this case, the preliminary (before credit) tax would be \(.21 \times (100 - 10) + .105 \times 100 = 18.90 + 10.50 = 29.40\). This amount is naturally larger than in the apportionment case. In this case, though, the incremental U.S. tax attributable to the foreign income certainly can be viewed as 10.50. A Section 904 limitation fraction that gives rise to this amount is \(.5 \times 100 / [(100 - 10) + .5 \times 100] = 5/14\). 5/14 of 29.40 = 10.5. The total U.S. taxes after credits = 29.40 - 10.50 = 18.90. This is the same as in first case.

- We can see again an interrelationship between the substantive rule and the credit system.

- This seems to be a reasonable result, if you accept the basic nondeductibility rule.
GILTI and Foreign Tax Credit Limitation: No Effect on Deductibility But Apportionment for Limitation

- Third Case: Under the relevant substantive deductibility rule, there is no effect on deductibility. But there is an allocation of interest expense for foreign tax credit limitation purposes. In this case, the preliminary (before credit) tax would be \(0.21(100 - 20) + 0.105(100) = 27.30\), significantly less than either of the first two cases. What is the “incremental” U.S. tax paid on the foreign source income? One possible way of thinking about it is that it is 10.5. But if we really take seriously the underlying concept of the apportionment for foreign tax credit purposes, we could say that 10 of the interest deductions (against 21 percent taxed income) would not have been incurred but for the foreign activities. If we did not have those operations, the tax would be \(0.21(100 - 10) = 18.90\); if we did have those operations, the tax is 27.30. The difference is 8.40. A limitation that reaches that result is \(0.5(100) - 10 / [(100 - 10 + 0.5(100) - 10] = 4/13\). 4/13 of 27.30 = 8.40. The total U.S. tax is 27.30 - 8.40 = 18.90 again.
Although the third case could actually be justified as a matter of the rules under Section 904, it does not seem to be the right place to end up as a matter of policy unless we choose to adopt one of the first two substantive deductibility rules.

The effect on overall taxation only occurs when the foreign tax credit rules are binding. Should taxpayers in tax havens be favored?

The key point is to determine proper allocation rules for substantive purposes, and then follow them for foreign tax credit purposes.