“Subpar” F? The Role of Anti-Deferral in a Post-GILTI (and Maybe Pillar Two) World

 Julie A. Roin and Julia Skubis Weber[[1]](#endnote-2)\*

The United States’ rules for the taxation of transnational income have morphed over the years in response to changes in economic and political conditions, not to mention developments in economic theory. Taxing regimes deemed appropriate in one era are rejected and replaced in another, only to be changed back at a later date, so much so that one noted scholar describes the United States’ international tax policy as a “seesaw.”[[2]](#endnote-3)

The United States, and the world more generally, seem to be at such an inflection point, rethinking the balance between source-based and residence-based income taxation. Although in theory the pre-existing consensus had been that the country in which income arose had the primary right to tax income generated within its borders while the taxpayer’s country of residence retained only a residual right to tax such income,[[3]](#endnote-4) in actuality the combination of tax treaties that restricted taxation by source countries[[4]](#endnote-5) and tax planning opportunities made possible by statutory and regulatory developments in source and residence countries, meant that many transnational taxpayers paid little to no tax on their income at source.[[5]](#endnote-6) Yet many of the tax regimes, like the United States’ subpart F regime,[[6]](#endnote-7) which were supposed to ensure that income protected against taxation at source would be taxed in the country of residence, simply failed to have the desired effect due to a combination of changes in underlying economic circumstances, governments’ engagement in tax competition, and taxpayer adaptation through planning. The result, in extreme cases, was what some have called “stateless income,” income that is taxed neither at source or in the country of residence.[[7]](#endnote-8)

Demonstrated instances of large, profitable multinational corporations achieving very low global effective tax rates have led to a revival of interest in buttressing the taxing rights of source states. The United States, though long perceived as primarily a residence state, has adopted its own statutory changes, including the base erosion anti-avoidance tax (“BEAT”)[[8]](#endnote-9) and limitations on interest deductions,[[9]](#endnote-10) aimed at extracting more tax revenues from foreign taxpayers operating in the United States. Other source countries have moved further and faster by, for example, promulgating digital services taxes.[[10]](#endnote-11) But the biggest changes—or proposed changes—have been developed by the Organization for Economic Co-operation and Development (“OECD”),[[11]](#endnote-12) through its Base Erosion and Profit Shifting (“BEPS”)[[12]](#endnote-13) project and its two-pillar “Inclusive Framework.”[[13]](#endnote-14)

Given these changes, this article asks what additional changes should be made in domestic U.S. law. In particular, it asks whether Congress should further reduce the scope of subpart F. Can parts of subpart F be jettisoned if (and when) all income is taxed at a reasonable rate at source, and when such source taxation is backstopped by a Pillar Two tax,[[14]](#endnote-15) a reformed GILTI tax[[15]](#endnote-16) or the new corporate alternative minimum tax?[[16]](#endnote-17) Or, should it revivify subpart F to ensure that all the foreign income of U.S. owned entities pay tax at the same rate as fully domestic taxpayers, even if that tax rate is higher than the tax rate paid by non-U.S. entities against which they compete in foreign (and even domestic) markets? Or something in between? In short, what is the “right” set of rules for the taxation of international income in this particular economic and political moment?

The article concludes that Congress should consolidate the proliferating regimes applicable to U.S. taxpayers’ controlled foreign corporations into a single minimum tax regime, one built on the framework of GILTI but improved and simplified to function as a “true” minimum tax. GILTI would be the primary anti-base erosion mechanism, with Subpart F serving only as an anti-avoidance provision targeting passive income and as a penalty regime for problematic industries and behavior that goes against public policy. Thus, subpart F’s foreign base company sales and services rules should be eliminated, and Code Sec. 954(c)(6) should be made permanent.

The first section of this Article explains the economic uncertainties and trade-offs inherent in crafting rules for residence country taxation of the income generated from international transactions, and describes Congress’ initial take on how to balance those concerns. The second section describes how this initial consensus crumbled in the face of taxpayer behavior and the development of a “multinational tax rate,” resulting in the enactment of subpart F. Part III explores the evolution of subpart F and taxpayers’ adaptations to preserve deferral while still enjoying low taxation at source. Part IV explores the revival of source-based taxation, both pre- and post-BEPS and its amelioration of the problems caused by subpart F’s ineffectiveness. Part V looks the recent development of competing regimes for residence taxation, such as GILTI, the new corporate alternative minimum tax on book income and the proposed Pillar Two proposal. Part VI asks whether and to what extent subpart F advances tax policy in light of these new developments in source and residence taxation. It suggests that much of what subpart F was meant to do would be achieved by a modified GILTI, possibly conformed to the Pillar Two GloBE tax mandated by the Inclusive Framework, and advocates the elimination of overlapping regimes in favor of a single, well-thought out and effective residence-based tax for most foreign business income. In short, assuming that Congress still adheres to its original consensus about the proper role of residence-based taxation,[[17]](#endnote-18) subpart F’s role should be restricted to the taxation of passive income and certain disfavored entities. Part VII concludes. This Article focuses on U.S. multinational corporate groups, not on subpart F as it applies to individuals or pass-through entities. It also assumes the persistence of the current two-tier structure of U.S. taxation of corporations and does not evaluate alternatives to this basic system, such as corporate integration with a dividends paid deduction.

# The Underlying Policy Dilemma

One cannot begin answering those questions without first confronting the inescapable policy dilemma underlying transnational tax policy. In a world in which different countries have different tax rates and different tax bases, it is impossible to achieve tax neutrality across all the relevant competitive frontiers at the same time. Assume, for example, that the U.S. tax rate is 21 percent and the Dutch tax rate is 15 percent, and that a U.S.-owned company, Acme Corp., produces widgets for sale to both Dutch and U.S. customers, while a Dutch-owned company, Nederland B.V., does the same. There is also a U.S. producer of widgets selling only in the U.S. market, Basic Corp., and a Dutch producer of widgets selling only to Dutch customers, Indus B.V. If the United States requires Acme to pay tax on all of its income, including its income from producing and selling widgets to Dutch customers, it will be at a competitive disadvantage compared to Nederland and Indus.[[18]](#endnote-19) Acme might even decide to reinvent itself as a Dutch corporation—and if it cannot,[[19]](#endnote-20) its example (of tax disadvantage) might encourage new businesses to set themselves up as Dutch corporations *ab initio*.[[20]](#endnote-21) Yet, if the United States does not require Acme to pay tax on all of its income at the full U.S. rate, Acme will have a financial edge over Basic when it sells into the U.S. market. That edge will not be any greater than the edge enjoyed by Nederland, when it sells into the U.S. market, of course—but that just brings us back to the original problem, the lack of tax neutrality between Acme and Nederland. In a world of unequal tax rates, Acme cannot be placed on the same tax footing as both Nederland (in the U.S. and Dutch markets) and Indus (in the Dutch market) while also remaining on the same tax footing as Basic (in the U.S. market). A choice must be made between the two competitive frontiers: is it more important for Acme to be equal to Basic (from a tax standpoint), or for Acme to be equal to Nederland and Indus?

Historically, the United States tried to finesse at least the appearance of this problem by requiring companies like Acme to pay tax on its worldwide income at U.S. rates—while also allowing Acme to carry out its foreign business operations through a foreign subsidiary, F Sub. F Sub, as a foreign corporation, typically with no U.S. source income, was not subject to U.S. tax—and its U.S. shareholder, Acme, was not subject to U.S. tax on F Sub’s income unless and until F Sub either distributed its income to Acme in the form of dividends or Acme sold its shares in F Sub. At the time of such distribution or sale, Acme was required to pay tax in the United States on the difference between the U.S. tax levied on that income and the income taxes already paid by F Sub to foreign governments, but many years could pass before that step-up tax (that is, the tax necessary to raise or step up its worldwide tax obligation to U.S. rates) was assessed and paid. In the interim, U.S. companies like Acme that conducted businesses in low-tax jurisdictions through foreign subsidiaries, such as F Sub, benefited from “deferral,” placing themselves at an advantage relative to their fully domestic competitors such as Basic (though, again, not necessarily relative to their foreign competitors, Nederland and Indus).[[21]](#endnote-22) And that economic advantage encouraged U.S. businesses to expand not in the United States but in low-tax countries, to the detriment of the U.S. economy and its tax base.[[22]](#endnote-23)

In the first part of the 20th century, then, the United States leaned in the direction of equalizing the tax treatment of Acme, Nederland and Indus, leaving Basic in the dust. It was not perfect equalization; unlike a territorial system, the U.S. tax system did eventually impose a step-up tax. But many years could pass before F Sub distributed dividends, and the cross-crediting permitted by the tax credit system often allowed the U.S. tax due on low-taxed foreign dividends to be offset by excess tax credits generated by high-taxed foreign dividends when such distributions were made. U.S. tax authorities were relatively complacent about the investment and revenue effects of the tax advantages enjoyed by U.S. multinationals utilizing low-taxed foreign subsidiaries, even (in some periods) going so far as to regard those tax effects as a desirable mechanism for delivering foreign aid.[[23]](#endnote-24)

# The Rise of Tax Avoidance

However, attitudes changed as U.S. multinationals learned how to structure their activities to pay tax at a lower effective rate than all non-multinationals, with the expected effect on business structures, national tax revenues, and the balance of payments in general (something governments used to worry about).[[24]](#endnote-25) In the first part of the 20th century, U.S. multinationals like Acme developed structures that allowed them to reduce the effective tax rate on foreign-connected (and some U.S.-connected) earnings below those prevailing in either the U.S. or the countries in which they sold their products or performed manufacturing or service activities. That is, Acme learned to set up F Sub (or a string of F Subs) in such a way that F Sub’s income was taxed at a lower effective rate than the rate imposed on either Basic or Indus—though perhaps not less than Nederland and its subsidiaries. U.S. multinationals learned, in short, to accumulate income in “foreign base companies” located in low-tax jurisdictions (often denominated “tax havens”).[[25]](#endnote-26)

The availability of this multinational tax advantage stemmed, in part, from two aspects of the tax system. One was the ubiquity of tax treaties which limited source countries’ ability to tax foreign corporations. Treaties prevented source countries from taxing the business income of treaty partner residents in the absence of a “permanent establishment” maintained in their country—and taxpayers learned how to conduct business without creating such a permanent establishment.[[26]](#endnote-27) Treaties also allowed a variety of tax base reducing payments (primarily interest and royalty payments) to leave jurisdictions without the imposition of a source tax.[[27]](#endnote-28) The second was tax authorities’ practical inability to police the prices charged by related parties for transactions among themselves, thereby providing a mechanism for allocating profits to corporations which were often in low-tax jurisdictions and low on substance.[[28]](#endnote-29) Source countries often found themselves left with little in the way of business profits to tax even when they had the right to impose a tax on the business.

Obviously tax planning to achieve the multinational tax rate could not have been so effective for so long without the cooperation of affected governments and their engagement in “tax competition.” First were the countries that set themselves up as tax-favorable locations for the base companies.[[29]](#endnote-30) But higher-tax countries were equally complicit. Tax treaties could have allowed more taxation at source, or high-tax countries could have refrained from entering into (or continuing) treaty arrangements with low-tax countries.[[30]](#endnote-31) The fact that they did neither indicated either that high-tax country governments saw such arrangements as mechanisms to deliver foreign aid, were happy to lure mobile multinationals to their shores by offering (somewhat hidden) tax favors, were afraid to put their Acmes at a disadvantage compared to Nederlands hailing from countries which had not taken such countermeasures—or that they caved to political pressures by affected taxpayers. Whatever the reason, the tax results were clear to both taxpayers and tax authorities. Paper transactions sufficed to locate income in tax-favorable jurisdictions. As a result, many multinationals enjoyed effective tax rates on their income well below those prevailing not only in the United States but also in other foreign jurisdictions in which they engaged in actual business operations. Such structuring provided them with an economic advantage relative not only to their domestic competitors but also to many foreign competitors as well.[[31]](#endnote-32) Essentially, what developed were three sets of tax rates: one for fully domestic enterprises, one for enterprises operating exclusively in one foreign jurisdiction, and a lower multinational tax rate for enterprises able to ascribe much of their operating income low-tax jurisdictions in which they engaged in little or no business activity. The incentive for U.S. companies to reorganize their operations—or to appear to reorganize their operations—to divert their income to entities resident in low tax jurisdictions grew more acute as knowledge of these techniques spread.[[32]](#endnote-33) Eventually, Congress responded by enacting subpart F.

# The Adoption of Subpart F

In 1962, Congress struck back against these tax minimization devices by enacting subpart F. While the initial legislative proposal would have required U.S. parent companies to pay U.S. tax on all of their foreign subsidiaries’ income as it was earned, Congress enacted a far less ambitious set of rules. The (then) new statutory regime was squarely directed at the special multinational tax rates made possible through the exploitation of foreign base companies. It targeted what was then considered “mobile” income. Only two types of income fit into the category of “mobile” income that could be effectively earned “anywhere”—passive income (e.g*.*, interest, rents and royalties) and sales income. The governing assumption, which made sense at the time, was that manufacturing (or non-sales) income required a factory, and factories were inherently immobile, while services needed to be provided on site to local customers.[[33]](#endnote-34)

With few exceptions, the regime allowed U.S. multinationals to continue to defer U.S. tax payments on foreign income ascribed to a country or countries in which the taxpayer engaged in an active business.[[34]](#endnote-35) U.S. companies with foreign operations could continue to pay the same tax as their local competitors (Nederland and Indus)—even when that tax was lower than the tax imposed on domestic U.S. businesses. That is, F Sub was allowed to pay the same taxes as Indus, even if those taxes were lower than those imposed on Basic. Subpart F was not designed to, and did not, eliminate the tax incentive to move manufacturing and other active business activities to lower-tax jurisdictions, nor to engage in these activities indirectly through foreign subsidiaries to benefit from deferral. Instead, it eliminated (or tried to eliminate) the tax incentive to locate income derived from such activities to subsidiaries resident in other, low-tax foreign jurisdictions, that had no connection to the production or performance of, or the target market for, the goods or services. It is this design aspect that some might call a “defect,” in that subpart F failed to “catch” taxpayers that adapted business operations to fit outside subpart F’s limited scope. Yet others would say that subpart F’s focus was to ensure that transactional structure aligned with the substance of business operations, and, to the extent taxpayers responded rationally to economic incentives and rearranged their operational substance to meet subpart F’s requirements, subpart F was indeed a “success.”[[35]](#endnote-36)

As a technical matter, subpart F required the U.S. shareholders of “controlled foreign corporations” (“CFCs”)[[36]](#endnote-37) to include on a current basis their distributive shares of those corporations’ “subpart F income.”[[37]](#endnote-38) Subpart F income had (and has) numerous specific components, but those components can be described as falling into three general categories. First, subpart F income included income derived from certain disfavored industries known for avoiding taxes, such as insurance[[38]](#endnote-39) and shipping.[[39]](#endnote-40) Second, subpart F income included “foreign personal holding company income,”[[40]](#endnote-41) which consisted of passive income such as interest, dividends and royalties that were not earned in the course of the recipients’ active business activities. Such income was easy to relocate, and, being passive in nature, did not raise any competitive concerns. That is, there was no reason to think that the competition between F Sub and Indus was more important to business success than the competition between F Sub and Basic when only passive income was at stake. Third and finally, subpart F income included income which was not only derived in connection with transactions with related parties, but which also resulted in the income being attributed for tax purposes to countries which had little relationship to the underlying income producing processes. “Foreign base company sales income” included income derived by a CFC from the sale of property purchased from, or sold to, a related person when neither the manufacturing activity nor the customer was located in that corporation’s country of residence.[[41]](#endnote-42) “Foreign base company services income” included the income derived by a CFC from the performance of services to or on behalf of a related person in a jurisdiction other than the one in which the corporation was located.[[42]](#endnote-43)

Transactions between related parties present particular challenges to tax authorities because of the difficulty of establishing an accurate price for such transactions, and thus of the income derived by each of the participants to such transactions. Although transactions between related parties are supposed to be effected using an “arm’s length price”, as a practical matter, such prices are frequently hard (and expensive!) to determine because of the absence of comparable arm’s length transactions. This left (and leaves) taxpayers with considerable flexibility in allocating income to lower-taxed entities. Taxes aside, no practical consequences flow from a division of jointly generated income. Ultimately, it all redounds to the benefit of the common parent (and its shareholders).

Tax authorities are also concerned when taxpayers interpose entities that have no obvious non-tax business justification for participating in the income-generating transactions, and which are residents of low-tax jurisdictions.[[43]](#endnote-44) In the mid-20th century, such entities were often corporations that engaged in very little business activity, or, if they did, it was the sort of business activity deemed to be “mobile” (i.e., sales and marketing functions). Even if the enterprise as a whole, taking into account the activities of all the related entities, rose to the level of an active trade or business, entities with little “real” connection to business activities (where “real” business was presumed to be manufacturing)—and especially ones in low-tax jurisdictions—appeared to exist only for tax reduction purposes, rather than as bona fide participants in the underlying business.

One way of explaining the contours of the foreign base company sales and services portions of the original subpart F regime is as a prophylactic measure against extreme (but hard to police) transfer pricing abuses, a prophylactic that worked by imposing a penalty tax on U.S. taxpayers whose corporate and business structures seemed too artificial.[[44]](#endnote-45) It forced such taxpayers to pay tax on the entirety of affected income at the U.S. rate and prevented them from enjoying the Indus rate. If they tried to go below the Indus rate by interposing a low-taxed intermediary with no operational connection to the business, they lost it all. The hope was that the regime would effectively eliminate the special multinational entity tax rate that fell below both the U.S. (Basic’s) tax rate and that prevailing in the jurisdiction(s) in which the foreign subsidiaries actually engaged in active business operations (the Indus rate). Although U.S. businesses still had an incentive to move their business operations to lower tax jurisdictions, to avoid the reach of subpart F, they would have to either: (1) manage to locate actual business activities in low-tax jurisdictions, or (2) pay tax at the Indus rate, leaving no room for them to enjoy a competitive advantage over Indus. When subpart F was enacted in 1962, the archetype of tax haven abuse was the shell corporation organized in an island nation in the Caribbean. In such a location, manufacturing capabilities were nonexistent and the provision of physical services to customers impossible. Thus, preventing subpart F’s application meant operating in a higher-tax jurisdiction. Whether this would put U.S. multinationals such as Acme at a disadvantage relative to foreign multinationals such as Nederland has always been a subject of dispute.[[45]](#endnote-46)

The problem, as laid out in the next section, is that, assuming subpart F’s objective was to prevent multinationals from enjoying the multinational tax rate, it did not adapt well to changes in the modernizing economy or to the degree to which a critical mass of jurisdictions engaged in tax competition. Subpart F could have, but did not, target mere rate disparities between Acme and Basic created by the use of foreign subsidiaries, even though such disparities created compelling incentives for Acme to invest outside of the United States (and thereby redirect both jobs and tax revenue away from the United States). Rather, subpart F was aimed only at a subset of corporate arrangements that were presumed to inappropriately reduce tax liability—specifically, those involving both related party transactions and what appeared to be artificial arrangements involving entities located in jurisdictions other than those in which manufacturing occurred, the people providing services were located, or where the CFC’s customers were. These restrictions on the scope of subpart F were in place for the foreign base company sales and services rules from the start, but, as we discuss below, with Code. Sec. 954(c)(6), they were extended to some passive income as well. The drafters of subpart F assumed that operational substance (manufacturing, performance of services) generally would occur in high-tax countries.[[46]](#endnote-47) However, as economies around the world modernized (and sought investment from U.S. companies to modernize further), they not only offered attractively low tax rates, but also became viable alternatives as locations for operational and even manufacturing activities.[[47]](#endnote-48) Critically, with the internet and digitalization starting in the late 20th century, service providers could perform services for customers anywhere in the world.[[48]](#endnote-49) And the rapidly globalizing economy provided strong business (i.e., non-tax) reasons for U.S. companies to invest substantially in regional centers that functioned as managerial, innovation, manufacturing, procurement, logistics and distribution hubs close to markets around the world.[[49]](#endnote-50)

Even before the issuance of the check-the-box regulations,[[50]](#endnote-51) taxpayers had opportunities to prevent subpart F’s application and, in certain cases, Acme could achieve a rate lower than that incurred by Basic or Indus. The structuring possibilities grew even more numerous once check-the-box became available.[[51]](#endnote-52) None of the tweaks Treasury imposed, such as the issuance of the contract manufacturing regulations discussed *infra* in Part III.A.1, had a significant effect on taxpayers’ ability to operate outside the scope of subpart F, although some significantly increased their financial and institutional costs. Subpart F, in short, became an (admittedly expensive) obstacle to be planned around rather than a bar to achieving the multinational tax rate. Taxpayers were forced to incur additional legal and accounting fees and make investments in foreign operations to avoid the reach of subpart F, but Treasury gained little in the way of additional tax revenues. The incentive for businesses to structure their operations as multinational entities only increased with globalization, and U.S. multinationals responded accordingly. Thus, the anti-base eroding effect that policymakers had hoped for did not materialize.

## The Rise and Fall of Subpart F

Congress did not want to disadvantage U.S. multinationals more than necessary to stamp out what it saw as efforts to take undue advantage of the U.S. tax laws. Subpart F’s statutory language was carefully and narrowly drafted to focus on transactions and structures identified as abusive in 1962. However, supply chains in 1962 looked very different from supply chains in 1992, and they were a world away from those in 2022. While Congress failed to update subpart F’s language to adapt to these new business practices, taxpayers grew ever more sophisticated in structuring their supply chains to avoid its reach. Avoidance often entailed increasing investments in “real” foreign business operations, which is the opposite of what Congress had hoped would be the effect of subpart F. It is worth keeping in mind that, given the pre-2017 U.S. corporate tax rate of 35 percent, a foreign effective tax rate did not need to be many percentage points lower than the U.S. rate to have a dramatic impact on a U.S. multinational’s bottom line. Eventually, both Congress and Treasury contributed to a progressive relaxation of the rules in ways that amplified subpart F’s ineffectiveness. It is worth going over a few examples[[52]](#endnote-53) of this evolution to illustrate two points. One is the ineffectiveness of subpart F in shutting down opportunities to relocate income to base companies incorporated in low-tax jurisdictions. The other is to make clear how difficult it is to craft language that would be effective in doing so without also impacting less abusive situations.

### The Manufacturing Exception

Code. Sec. 954(d)(1) defines “foreign base company sales income” to include income generated from the purchase or sale of property from or to a related party when the property is neither manufactured in nor sold to a customer located within the CFC’s country of incorporation.[[53]](#endnote-54)

This language covers situations in which property is manufactured by one corporation (Corp 1) in one jurisdiction (Country A) is sold to a related corporation (Corp 2) located in a second (low-tax) jurisdiction (Country B), which in turn sells the property to unrelated customers located in a third jurisdiction (Country C). It also covers situations in which a corporation (Corp 3) located in a low-tax jurisdiction (Country D) buys goods from an unrelated corporation and resells those goods to a related corporation (Corp 4) in another jurisdiction (Country E). Both structures enable a common U.S. parent company (i.e., the U.S. owner of both Corp 1 and Corp 2, or the U.S. owner of Corp 3 and Corp 4) to allocate the lion’s share of the joint profit derived from the combination of Corp 1 and Corp 2’s activities or Corp 3 and Corp 4’s activities to the low-tax entity—i.e., to Corp 2 or Corp 3—through aggressive transfer pricing.[[54]](#endnote-55) Although as a technical matter, transfer prices have always been susceptible to challenge by the IRS acting under the authority of Code. Sec. 482,[[55]](#endnote-56) Code. Sec. 482 cases are expensive to prosecute and difficult for tax authorities to win. Subpart F was meant to function as a prophylactic measure given the realities of transfer pricing enforcement. Subpart F treats both Corp 2 and Corp 3 as immediately distributing their respective profits to their U.S. shareholders, thus preempting any potential tax benefits that might otherwise have been derived from presumably artificial income shifting through transfer pricing.

However, foreign base company sales income was not supposed to include income derived from manufacturing activities, or combined manufacturing and sales activities.[[56]](#endnote-57) When a low-taxed Corp 2 or Corp 3 is treated as engaged in manufacturing as well as selling, subpart F has no purchase. Thus, taxpayers had a strong incentive to ensure that foreign subsidiaries with related-party sales (often established in lower-tax jurisdictions) were accorded “manufacturing” status for U.S. tax purposes.

The original subpart F legislation’s inclusion of a “branch rule”[[57]](#endnote-58) prevented a CFC from carrying out manufacturing and sales activities through separate branches, each of which was (for foreign tax purposes) taxable only on the income of said branch. Suppose, for example, a corporation resident in a low-tax jurisdiction manufactured goods through a branch located in a high-tax jurisdiction, but that branch did not engage in any sales activities. Although the manufacturing income would be subject to tax in that high-tax jurisdiction, the sales income derived by other parts of the corporation (located in lower-tax jurisdictions) from selling those goods would fall outside the high-tax country’s tax jurisdiction if that country operated a territorial tax system. Such separations of manufacturing income from sales income, of course, generated a transfer pricing problem for the taxing authorities of the two countries in which the branches are located. From the U.S. perspective, though, the branch would not be viewed as separate from its corporate owner, so that, absent special rules, the CFC would be viewed as a manufacturer as well as a seller, and its transactions would not create foreign base company sales income. However, Congress foresaw the avoidance opportunities offered by this structure, and foreclosed it by including a “branch rule” in Code Sec. 954(d)(2). The branch rule requires each branch of a corporation to be treated as a separate subsidiary, and for transfers between them and the CFC “remainder” to be treated as sales, in any situation in which “the use of the branch or similar establishment…has substantially the same tax effect as if the branch or similar establishment were a wholly owned subsidiary corporation of such controlled foreign corporation.”[[58]](#endnote-59) According to the regulations, arrangements are deemed to have “the same tax effect” if the income derived by one of the branches was subject to an effective rate of tax that is “less than 90 percent of, and at least 5 percentage points less than” the hypothetical effective rate of tax that would be applicable to the income of the remainder.[[59]](#endnote-60) Branch arrangements, in short, fall under the purview of subpart F whenever they substantially reduce foreign tax liability.[[60]](#endnote-61)

But what if a low-taxed corporation contracts with a high-taxed corporation (which could be related or unrelated) not for the purchase of manufactured products, but instead for the performance of manufacturing services? As in the branch scenario, the manufacturing entity would be subject to tax on its manufacturing income at a high tax rate. What about the income generated by the low-taxed corporation? If that corporation were deemed for tax purposes to be engaged in manufacturing as well as selling—if the manufacturing activities of its contractual agent were imputed to it—its income would not be taxed under subpart F. If such transactions worked, a taxpayer could derive the tax effects foreclosed by operation of the branch rule through a carefully drafted services contract.

One fear was that the U.S. tax authorities would regard even separately incorporated entities as a “branch” of the CFC, thus triggering application of the branch rule. However, in two taxpayer-favorable decisions, courts held that separately incorporated entities do not constitute “branches” and thus that such arrangements were not affected by the branch rule.[[61]](#endnote-62)

The other fear was that the IRS would not allow the contract manufacturer’s manufacturing activities to be attributed to the CFC that contracted for their performance. For many years, the U.S. tax authorities allowed contracted-for manufacturing work to be imputed to the purchaser of the services for U.S. tax purposes,[[62]](#endnote-63) thus keeping the CFC’s income outside of the definition of foreign base company sales income. Treasury’s issuance of regulations aimed squarely at contract manufacturing situations expressly deemed a CFC to be engaged in manufacturing as a result of contract manufacturing arrangements. Instead of directly confronting (or allowing) the issue of “imputation” from another entity, the Treasury Regulations detailed the circumstances under which the tax authorities would conclude that the CFC was itself engaged in manufacturing, allowing the income of such CFCs to escape foreign base company sales income status even in the absence of an imputation of the actions of the contract manufacturer. When Treasury proposed the contract manufacturing regulations in 2008, it explained that Rev. Rul. 97-48 (revoking the blessing previously bestowed on imputation of a contract manufacturer’s activities) did not “address the circumstances under which the activities of the CFC itself may qualify as manufacturing when a contract manufacturing or similar arrangement is in place.”[[63]](#endnote-64) The regulations then detailed the activities that, if carried out by a CFC, would amount to the “substantial contribution” to the manufacturing process necessary to characterize the activities of the CFC itself as “manufacturing activities.”[[64]](#endnote-65)

The regulations require the corporate principal to “make a substantial contribution through the activities of its employees to the manufacture, production, or construction of the personal property sold” to be deemed engaged in manufacturing.[[65]](#endnote-66) A major difference between pre-existing practice and the demands of the new regulations lay in the regulations’ requirement that these activities be conducted by employees of the corporate principal. The regulations, finalized at the end of 2008, acknowledged the contemporary realities of taxpayers’ manufacturing networks and supply chains. The fact was that contract manufacturing was a reality, and not just for tax reasons, but for purposes of overall cost, flexibility and efficiency.[[66]](#endnote-67) While many commenters noted that the standard set in the list of factors was both vague and unrealistic (particularly the requirement that activities be performed by the CFC’s own employees),[[67]](#endnote-68) in practice taxpayers have used the many regulatory examples to divine a sort of safe harbor, albeit one that is usually costly to establish and maintain, and that attracts scrutiny from IRS examiners. By and large, however, the contract manufacturing regulations enhanced CFCs’ ability to satisfy the manufacturing requirement of subpart F.[[68]](#endnote-69)

Contract manufacturing arrangements only make tax sense, however, to the extent the taxpayers could convince the appropriate tax authorities that related high-tax manufacturers properly derived income only from the performance of “routine” manufacturing services, and that related re-sellers also earned income from the performance of “routine” sales activities, leaving the bulk of the income derived from manufacturing and selling the goods to be allocated to the low-taxed, risk-bearing (principal) entity.[[69]](#endnote-70) It is relatively easy to justify prices providing the desired low returns to sellers or contract manufacturers when the low-taxed principal entity owns the valuable intellectual property (“IP”) necessary for, and absorbs the business risks inherent in, carrying out the manufacturing and sales activities. Although the manufacturer used these valuable intangible assets when carrying out its obligations under the contract, the return for this use belonged to their owner.[[70]](#endnote-71) Manufacturing service providers deserved only a modest, cost-plus return for what amounted to “plain vanilla” manufacturing activities—even when the products being manufactured were high-value products (such as a smart phone) incorporating valuable IP. The same argument (about ownership of IP and assumption of business risk) was used to justify allocating relatively little income to the official distributors of the products in high-tax countries.[[71]](#endnote-72)

Note that, as a substantive matter, the low-taxed principal entity’s income actually stems from its ownership of intellectual property. Such income from IP that is exploited by another party is usually denominated a “royalty,” which is a type of passive income that is often included within the definition of foreign base company income for subpart F purposes. The economic return enjoyed by a manufacturer exploiting IP for its own benefit is best described as a combination of an “imputed” royalty on its IP plus a return on its manufacturing activities. However, the U.S. tax authorities generally do not bifurcate such returns, instead treating the entirety of the manufacturers’ return as manufacturing income, income which falls outside the definition of foreign base company income and outside the purview of subpart F.

The manufacturing exception provided taxpayers with opportunities to prevent subpart F’s application, but to ensure the exception’s application, taxpayers needed to arrange their business operations in a particular way. If the CFC directly operated a plant, the analysis was straightforward; if the CFC engaged a contract manufacturer, the arrangement needed to comply (as much as possible based on the multi-factor test) with the regulations to establish that CFC’s substantial contribution to the manufacturing process. In contrast, the check-the-box rules described in the next section presented opportunities to avoid subpart F that required no operational changes whatsoever.

### Check-the-Box

In 1997, Treasury decided to discontinue the onerous and expensive process of policing of the distinction between corporate and non-corporate entities.[[72]](#endnote-73) It adopted the so-called “check-the-box” regulations,[[73]](#endnote-74) which allow taxpayers to determine whether a given business subdivision would be treated as a corporation or as a flow-through entity (either a partnership or a disregarded entity not treated as separate from its regarded owner) merely by checking a box on a form. Importantly, these characterizations (as a separate corporate entity or a disregarded entity) for U.S. tax purposes are not effective for foreign tax purposes. That is, an entity with few or no employees and business activities resident in a low-tax jurisdiction could be treated as a “tax nothing”—just a branch of another foreign subsidiary located in a higher tax jurisdiction—for U.S. tax purposes, while being treated as a separately incorporated, foreign entity for foreign tax purposes.[[74]](#endnote-75) While the check-the-box regulations made the entity classification exercise much easier, they upended the application of subpart F, which depended on treatment of a foreign subsidiary as a corporation and the existence of “regarded” transactional flows for U.S. tax purposes. Such inconsistent characterizations made it possible for a high-taxed foreign subsidiary of a U.S. corporation to reduce its high-taxed foreign income by making a (foreign tax) deductible royalty or interest payment to the low-taxed entity. If the low-taxed entity resided in a country with a tax treaty with the high-tax country, no withholding tax would be levied on the outgoing payments to the low-taxed entity, and the foreign tax levied on the recipient by the low-tax jurisdiction would be, well, low. The U.S., meanwhile, would disregard the payments between the high-taxed and low-taxed entities for tax purposes because, for U.S. tax purposes, the two entities are one and intra-corporate payments are disregarded.[[75]](#endnote-76) Thus, the payments would fall outside the scope of the definition of foreign personal holding company income and the subpart F regime and escape immediate U.S. taxation.[[76]](#endnote-77)

Take, for example, a U.S. parent company that transferred early-stage IP to F Sub pursuant to a “cost sharing arrangement” as described immediately *infra* in Part III.A.3. F Sub could license the IP to a disregarded principal company, which would then use the IP to generate sales or services income. F Sub avoided subpart F income by ensuring that it was treated as a manufacturer or by engaging in purchasing, sales and services transactions with third parties. It also avoided foreign tax because, although the disregarded principal company was subject to tax in its country of incorporation, that tax was largely eliminated due to the sizable, deductible (for foreign tax purposes) royalty to F Sub. F Sub’s royalty income, in turn, was disregarded for U.S. federal income tax purposes. If the disregarded principal and F Sub were organized in countries with a tax treaty, or both were members of the European Union, there would be no foreign withholding tax imposed on the royalty payment to F Sub. And a common technique to eliminate foreign taxation at the F Sub level would be to incorporate F Sub in an EU country (e.g., Ireland) but make it tax resident in an ultra-low (or no) tax jurisdiction (e.g., Bermuda). In those cases, the all-in foreign tax liability could be whittled down considerably.[[77]](#endnote-78) The absence of a branch tax rule in the definition of foreign base company services income and foreign personal holding company income, meanwhile, prevented the IRS from recharacterizing transactions between the “branches” of F Sub (i.e., between F Sub and its disregarded entities) as transactions between related corporations. Thus, the only royalties or fees the U.S. tax system would see were those derived by the original (head office) F Sub, which were clearly derived in connection with its undeniably active trade or business.

Almost as soon as the check-the-box regulations were issued, the IRS realized the opportunities they created for foreign base erosion (such as the above-described IP structuring) that fell outside of subpart F’s grasp. Treasury and the IRS tried to correct this outcome with Notice 98-11 and the temporary and proposed regulations that followed.[[78]](#endnote-79) However, the attempt was unsuccessful.

### Approaches for Allocating Income to F Sub

Allocating profits to a particular foreign subsidiary requires that the subsidiary have a claim to those profits under transfer pricing principles. This usually requires the low-taxed foreign entity to own valuable intellectual (or other) property or capital, and/or assume substantial business risks. It is ownership of those critical profit drivers that justifies the low-taxed entity’s claim to the lion’s share of the overall enterprise’s income. Often, companies can make payments to each other, even cross-border payments, with minimal tax consequences. The same cannot be said for IP and appreciated tangible property. Transfers of IP are treated as realization events under U.S. tax law, triggering either an immediate gain in the hands of the transferor or the formation of a constructive license carrying deemed royalties. In either case, most if not all of the economic benefits attributable to such property would be included in the income of the (presumably high-taxed) transferor on a current basis. Effecting a transfer of technological rights from a U.S. corporation to a low-taxed foreign subsidiary would negate most if not all of the tax benefits of having the low-taxed foreign subsidiary own the technological rights.[[79]](#endnote-80)

U.S. taxpayers have options for relocating IP rights for U.S. tax purposes without triggering gain, however. The cost sharing regulations in Reg. § 1.482-7 bless the concept of a “cost sharing arrangement,” alluded to in Part III.A.2, *supra*, under which a U.S. parent company and an F Sub may share the cost of developing IP. While a full exploration of cost sharing is outside the scope of this Article, a very rudimentary description follows. The U.S. parent company would transfer some IP to F Sub at a very early stage of development. F Sub would have to pay the U.S. parent for this property in the form of a “platform contribution transaction,” or “PCT,” payment (also referred to as a “buy-in” payment), determined according to the valuation methodology specified in the Code. Sec. 482 regulations. F Sub would also have to make payments towards the cost of the further developing the property. Under the terms of such an agreement, F Sub would be regarded as the owner (or part-owner) of the fully developed property. F Sub could then allow a contract manufacturer to use this property under the terms of a contract manufacturing agreement, or it could license the IP to a disregarded principal company. The disregarded principal would then derive the benefits of IP ownership through sales of products or the provision of services to customers. The use of disregarded entities to arrange these tax-efficient structures, particularly those centering around the ownership and development of intangible property in a foreign subsidiary, evolved into a well-worn path.[[80]](#endnote-81) Cost sharing is not the only means of effecting this economic result, as licenses bearing royalties based on sales can place IP rights at F Sub, enabling F Sub to bear the burden of DEMPE functions, as well as the risk of development, with respect to the IP and earn the associated profits in the event the developed product is successful.

### The Addition of Code Sec. 954(c)(6)

The above-described planning approaches and increasing regulatory flexibility allowed U.S. multinationals to expand their global operations while avoiding subpart F and reducing the effective tax rates of operating companies located in high-tax countries. This, of course depended on the conduct of business activities abroad, which was sanctioned by subpart F, but it enabled the very “multinational tax rate” that was the impetus for the passage of subpart F in 1962. By the late 1990s, some tax experts were beginning to ask whether this was really a problem. As David Tillinghast observed,

We would normally not think that the policy of subpart F had been offended simply because a foreign country allowed as a deduction in computing its tax an item that the United States did not consider to be a deductible payment (or a payment at all). On the other hand, there can be little doubt that the branch rule of the check-the-box regulations makes it likely that, absent changes in foreign law, effective tax rates on foreign operations will be substantially reduced while U.S. tax is deferred.[[81]](#endnote-82)

From the point of view of American business, the response to foreign rate reduction was, “So what?” If Acme’s Dutch subsidiary, F Sub, was to compete with the Nederlands of the world, why should F Sub be penalized for achieving the same effective foreign rate of tax that Nederland could achieve? The government’s concern, of course, was the disparate treatment and competitive footing of Acme as compared to Basic, and the fear that this disparity would draw the capital of U.S. multinationals offshore, and away from the U.S. economy and fisc.[[82]](#endnote-83) After all, the statutory language of Code Sec. 954 did not distinguish between transactions that eroded the U.S. tax base directly, by reducing the income of U.S. operating companies, and those that eroded it indirectly by making U.S. investment in what had been high-tax countries more attractive—and more attractive than investment in the United States.

In its 2000 policy study, Treasury outlined how foreign-to-foreign base erosion directly affected tax revenue earned by the United States. It presented two examples to illustrate its position.[[83]](#endnote-84) In its first example, the U.S. parent had a CFC subject to foreign tax at a rate higher than that prevailing in the United States. The most tax-efficient structure would have the U.S. parent lending its money to finance the CFC’s operations. The interest payments made with respect to those loans would erode the tax base of the foreign jurisdiction while increasing that of the United States. In addition, interest payable by a CFC with respect to a loan from a regarded low-taxed affiliate would be taxed at the full U.S. rate as foreign personal holding company income. In neither case would the foreign investment be tax-favored relative to domestic investment. The option presented by a low-taxed disregarded entity, however, upset this balance, as the high-taxed CFC could deduct interest payments that generated little or no tax in the lender jurisdiction, without tripping subpart F. The disregarded lender—and the foreign investment—was therefore the obvious choice from a tax standpoint. In the second example, which is somewhat similar to the IP structure described in Part III.A.3, above, a disregarded entity entered into a CSA with the U.S. parent, then licensed the IP to the regarded owner. The license fees were considered by Treasury to be royalties that the U.S. parent “should” have received, with the result that each “dollar of profits shifted from the U.S. parent to the subsidiary’s operations is an average of the statutory tax rates of the countries hosting the subsidiary and the hybrid entity.” Once the royalty payments were disregarded, they escaped taxation under subpart F while engendering little in the way of foreign tax liability.

The dispute, of course, boils down to the dispute outlined in Part I, above: what matters more, protection of the tax and economic base (i.e., ensuring the tax equality of Basic and Acme) or ensuring that Acme is competitive with Nederland? What some see as a valid interest in penalizing the use of techniques to minimize foreign effective tax rates, others see as unwarranted interference with U.S. companies’ ability to do business in foreign markets. From the point of view of many U.S. companies, the decision regarding *whether* to invest in foreign operations was not a toggle depending on the availability of tax incentives—rather, it was a given. Of course, the degree to which to invest, and where, and in what legal entity structure, was sensitive to a number of inputs, including tax costs.[[84]](#endnote-85) The United States had two structural features in place that contributed to those more nuanced decisions: the 35 percent corporate rate and subpart F’s requirements for conduct of substantial business operations in the local production and/or market jurisdictions. Particularly as widespread tax competition drove down corporate income tax rates across the board,[[85]](#endnote-86) the multinational tax rate grew more valuable, and even costly investments to prevent the application of subpart F were worthwhile.

What seems beyond dispute is that Congress changed its position on the debate regarding foreign-to-foreign base erosion in 2006: it called off subpart F for income generated through business transactions with no direct connection to the United States. Specifically, Congress added Code Sec. 954(c)(6) to the Code. This section of the Code explicitly exempts from the definition of foreign personal holding company income “dividends, interest, rents, and royalties received or accrued from a controlled foreign corporation which is a related person” as long as the income derived by that related person “is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States.” Code Sec. 954(c)(6) represented a Congressional retreat from policing foreign-to-foreign base erosion.[[86]](#endnote-87) As a result of this provision, at least until December 31, 2025,[[87]](#endnote-88) CFCs may make deductible payments to other CFCs, provided those payments are made out of non-subpart F and non-effectively connected income, without application of subpart F.[[88]](#endnote-89) The low-taxed entity to which such earnings are moved of course has to be entitled to receive them (i.e., it has to have supplied capital and/or intellectual property and/or other property and/or accepted business risk), but such entities rarely have to worry about earning foreign personal holding company income. Check-the-box maneuvers became much less important, at least from the U.S. standpoint.[[89]](#endnote-90)

## What is Left of Subpart F?

While it may be an overstatement to say that subpart F is dead, it is clearly on life support. After enactment of Code Sec. 954(c)(6), it (and by implication the United States) has a limited role in preventing U.S. multinationals from shifting income from one foreign jurisdiction to another. From the U.S. perspective, it now seems to be a matter of indifference whether foreign countries try to attract U.S. business investment by reducing their statutory tax rates or by allowing taxpayers to reduce their effective tax rates through tax planning.[[90]](#endnote-91) Code Sec. 954(c)(6) does not apply, however, to the extent the income being reduced by the deductions is income “effectively connected with a U.S. trade or business” or is, itself, subpart F income of the payor CFC. Subpart F can still operate to protect the U.S. tax base, at least in theory. In practice, however, the techniques such as contract manufacturing and even cost-sharing agreements employed to bring transactions outside the scope of subpart F may continue to be used to reduce the tax base of foreign-parented U.S. operating companies and shift their income to low-taxed foreign entities. But, of course, subpart F never applied to foreign-parented multinational entities, only U.S. parented ones.

Escaping from coverage by subpart F—and diverting income to a low-tax foreign subsidiary—is only advantageous if and to the extent the taxpayer can avoid taxation at source, or at least reduce it to a level that is lower than taxation at the full U.S. rate. If the foreign taxes levied on foreign source income approximate the U.S. tax that would have been imposed on such income had it been earned and taxed domestically, subpart F would have no sting. And indeed, income bearing such a foreign tax may, at the election of the taxpayer, be excluded from the definition of subpart F income even if it otherwise falls within the definition of foreign base company income for precisely that reason.[[91]](#endnote-92) It is the avoidance of source taxation (the tax paid by Indus) that creates the “multinational tax rate” in the first instance. The reason the tax planning discussed above thrived was not just because the structuring prevented application of subpart F, but also because the foreign source countries did not sufficiently police their own base erosion[[92]](#endnote-93)—at least, until relatively recently. That hands-off attitude is changing.

Over the last decade, many countries have increasingly asserted taxing jurisdiction over foreign taxpayers and the income they generate within their borders. Interestingly, the United States has, in many cases, been in the forefront of such movements—but only for purposes of enforcing its own source tax claims. It has been less supportive of other countries’ efforts to do the same. This attitude might be changing; it is among the signatories of the Inclusive Framework[[93]](#endnote-94) established under the auspices of the second wave of the OECD’s BEPS project (“BEPS 2.0”) in the summer of 2021, which would allow greater source taxation. Even in the absence of U.S. support, though, many countries have moved to implement recommendations made under “BEPS 1.0,” which have had the effect of increasing taxation at source. Some of these changes have already reduced or eliminated the benefits obtainable from the tax minimization strategies explained earlier, thereby compensating, at least in part, for subpart F’s loss of effectiveness.

# The Resurgence of Source Taxation

As an historical matter, the United States preferred residence country taxation to source country taxation, a preference exhibited in its source-tax reducing bilateral tax treaties. It routinely resisted treaty provisions which would have generated reciprocal increases in source taxation. This stemmed (at least in part[[94]](#endnote-95)) from its perceived economic position as primarily an exporter of capital. Although U.S. companies can be enticed to invest abroad with low foreign tax rates,[[95]](#endnote-96) those same low rates were supposed to ensure that the U.S. Treasury collected more tax when the money was brought back to the United States. U.S. politicians and tax authorities seemed to view reductions in foreign tax claims on balance as advantageous to the U.S. Treasury.[[96]](#endnote-97) Whether such a policy ever made sense is unclear; given deferral and defects in the operation of the foreign tax credit system—primarily the extent of cross-crediting that reduced the extent of residence country taxation—the U.S. Treasury rarely collected much income attributable to the foreign operations of its multinationals.[[97]](#endnote-98)

In recent years, the United States has become increasingly interested in ensuring that profits from foreign businesses operating in the United States be taxed by the United States. It has been less supportive, however, of efforts by other countries to increase source taxes that would fall on the foreign operations of U.S. multinationals.[[98]](#endnote-99) The United States has been reluctant to help foreign governments impose taxes that would, in theory, affect all multinationals, because in practice these taxes often tend to differentially impact Acme while avoiding Nederland and Indus.[[99]](#endnote-100) But many foreign countries have not waited for U.S. approval, and have moved in the direction of increasing source taxation. Although some of these legal initiatives have resulted from unilateral actions, many others relied on the technical and political suasion of the OECD’s BEPS project, a project initiated by the OECD in 2015.

## Pre-BEPS Source Tax Increases

Source countries’ taxing powers are often ceded to the taxpayers’ country of residence by treaty. But when the residence country fails to exercise its treaty-allocated powers, income goes untaxed creating the multinational tax rate. Since simply cancelling the treaties used to create such tax gaps is not always desirable or possible, some countries developed techniques for limiting their harms. One was to reduce their scope by narrowing the definition of the persons eligible to claim the protections offered by the treaties; another was to narrow the definition of income items granted treaty relief. The United States has done both, and was largely supportive of other countries that did the same, even though the effect of those foreign changes may have been to increase the taxation at source of U.S. multinationals.

### Limitation on Benefits Provisions

The United States was a leader in drafting and promoting the use of limitation on benefits clauses in tax treaties.[[100]](#endnote-101) The point of these clauses was to make it more difficult (if not impossible) for residents of a third country to claim entitlement to source tax reductions, such as the elimination of the withholding tax on outbound interest, royalties and dividends, by establishing a shell corporation in a treaty partner. Limitation on benefits provisions made it more likely that source tax reductions would be matched by offsetting residence tax inclusions, reducing the likelihood of income escaping taxation everywhere. Although the United States’ interest stemmed from its perceived need to protect its own source tax base (i.e., with the possible undertaxation of foreign multinational enterprises), it set an example for other countries which added similar provisions to their tax treaties with non-U.S. countries.[[101]](#endnote-102)

### Interest Limitations

A common tax planning technique paired a payment treated as a deductible expense by the payor with a treaty exclusion for the (related party) payee—a payee which, in turn, was not subject to tax in its country of residence. Such payments essentially dropped out of the tax base for long periods of time. Related-party loans were one of the simplest transactions used to achieve deductible payments. A treaty-protected, low-tax entity would lend money to a related party engaged in business operations in a high-tax country. At the end of the day, the entity located in the high-tax county would have little in the way of taxable income, while the low-tax entity would be flush with cash (and low-taxed income).

Countries increasingly reacted to this planning by placing a statutory cap on the amount of interest deductible by a payor. The loss of the deduction increases the payor’s taxable income and tax liability. Such disallowances are economically equivalent to subjecting the interest to tax at the payor’s ordinary income tax rate.

Many European countries have “thin cap” rules that “limit the amount of interest a multinational business can deduct for tax purposes.”[[102]](#endnote-103) Not only did the United States not object to such rules, it eventually decided to copy them to protect against the undertaxation of foreign multinationals operating within its borders. After cycling through several different alternative approaches,[[103]](#endnote-104) in 2017, Congress enacted a hard cap on interest deductions for all taxpayers, not just transnational ones.[[104]](#endnote-105) Code. Sec. 163(j) disallows deductions for interest expenses in excess of the business interest income of a taxpayer for such taxable year plus 30 percent of the taxpayer’s adjusted taxable income for such taxable year. As a result, 70 percent of all of a business’s operating income has to remain subject to tax at normally applicable tax rates; any disallowed interest deductions are effectively subject to tax at the 21 percent rate.[[105]](#endnote-106) However, Code. Sec. 163(j), like other thin capitalization rules, does nothing to forestall income stripping using non-interest deductions such as royalties or, for that matter, products or services purchased from a related foreign company.

Publicly traded U.S. multinational companies generally did not worry about limitations on treaty benefits, interest barriers and foreign CFC regimes[[106]](#endnote-107) as they did not provide insurmountable obstacles to achieving the favorable multinational tax rate. However, some combination of public exposure and financial pressure caused a shift in the political mood in the early 2010s,[[107]](#endnote-108) leading to systemic efforts to increase the taxation of all multinational enterprises. These efforts were spearheaded by the OECD—often but not always in the face of U.S. opposition.

## BEPS 1.0

The OECD and many academics have long been worried about the deleterious effects of tax competition. Its initial focus was on the behavior of source countries and, in particular, their attempts to attract investment by offering low tax rates. Its 1998 report entitled *Harmful Tax Competition: An Emerging Global Issue*[[108]](#endnote-109) differentiated between “harmful preferential tax regimes,” and “acceptable” ones.[[109]](#endnote-110) Only later did it grow concerned specifically with taxpayers’ ability to produce “stateless income.” Governmental investigations in the United States and United Kingdom—investigations that garnered considerable media attention—revealed the extent of multinational enterprises’ ability to avoid taxation everywhere as a result of careful tax planning that made use of a combination of tax treaties, preferential tax regimes, and tax incentives granted under private rulings.[[110]](#endnote-111) After these investigations and the subsequent media storm, the G20 leaders “expressed strong support for international cooperation to combat tax avoidance [and]….delegated to the OECD the task of coordinating multilateral efforts….”[[111]](#endnote-112) This effort, the BEPS Project, launched in 2012. Its charge was to come up rules for the elimination of the harmful tax rules and practices which enabled multinationals to shift profits to low-taxed entities located in low-tax jurisdictions that had minimal connection to actual income-generating activities.[[112]](#endnote-113)

By 2015, BEPS 1.0 had issued reports on 15 “actions” that countries could undertake to reduce base erosion. Many of these “action items” were specifically directed at the strategies identified in Part III.A, such as transfer pricing and hybrid structures, used by U.S. (and foreign) multinationals to reduce taxation at source. And although not every country adopted all of the recommendations, numerous changes were made to national laws that had the effect of imposing additional burdens on U.S. (and other) multinationals.

### Hybrid Entities

One of the BEPS project’s first targets was the deduction / no inclusion arrangements employing hybrid entities that were described in Notice 98-11.[[113]](#endnote-114) BEPS Action 2 called for “[n]eutralising the effects of hybrid mismatch arrangements,” and led to the issuance of a report detailing the legal changes that could be enacted to prevent taxpayers from gaining tax benefits by characterizing payments and entities one way for one government and another for another government.[[114]](#endnote-115) The United States followed these recommendations and enacted rules to prevent base erosion by foreign multinationals with U.S. activities,[[115]](#endnote-116) but it was not alone in doing so. Many of its major trading partners, including the members of the EU, enacted similar rules to forestall the use of hybrid entities and hybrid instruments to erode their tax bases.[[116]](#endnote-117) As a result, structures involving hybrid entities and/or instruments no longer work as well as they once had,[[117]](#endnote-118) forcing U.S. based multinationals to pay more tax at source on their foreign earnings.

### Permanent Establishments

As a general rule, treaties prevent countries from taxing the business income of residents of a treaty partner in the absence of a “permanent establishment.”[[118]](#endnote-119) Concern about the ease with which multinational investors could avoid establishing permanent establishments in high-tax countries, thereby avoiding source taxation of business income under the terms of prevailing treaties, surfaced in discussions at the OECD long before BEPS. In the first place, many modern businesses can be carried out in the absence of a physical establishment—an essential predicate for a permanent establishment—or at least a physical establishment located near customers. Many services, for example, can be provided remotely, or through agents with no fixed base. Business consultants might work at temporary offices provided by their clients; technology companies might sell ads or perform services at a great remove from their customers. In addition, many multinationals could prevent the creation of permanent establishment in high-tax countries by using “independent agents” to carry out any necessary business activities.[[119]](#endnote-120) This often was not difficult given that wholly owned subsidiaries, if properly structured, could be considered “independent agent” for these purposes.[[120]](#endnote-121) Still other multinationals avoided the creation of a permanent establishment because local agents did not have “the power to conclude contracts in their name,”[[121]](#endnote-122) and instead all sales contracts had to be approved and finalized at a foreign office located in a low-tax jurisdiction. As a result of these strategies, many multinationals earned substantial sums in countries which were legally prohibited from imposing taxes on them.

Even before BEPS, the tax authorities of some countries began to look past formal contractual arrangements to assert the existence of permanent establishments in a wide variety of situations in which the United States would refrain from doing so. For example, some distinguished between situations in which home office approval is a mere formality and those in which the home office actually performs substantial risk analysis and oversight of the contractual process. Where home office approvals were perfunctory, in-country agents were treated as “concluding contracts on behalf of the enterprise” generating a permanent establishment. Others became eager to treat wholly owned subsidiaries as dependent agents due to their lack of financial and business independence.[[122]](#endnote-123) However, they often did so in the teeth of disapproval by the United States[[123]](#endnote-124) and generally without the backing of the OECD.[[124]](#endnote-125) Although the OECD went so far as to promulgate drafts of “alternate” tax treaty provisions and treaty commentary that it deemed unobjectionable, it was not until BEPS 1.0 that the OECD recommended changes to its Model Tax Treaty and commentary that would, if adopted, result in U.S. (and other) multinationals having many more permanent establishments, leaving them open to taxation at source by more countries.

BEPS Action 7 not only accepted many of the previously proposed tax treaty alterations, but added to them in order to “prevent the use of certain common tax avoidance strategies used to circumvent the former Model permanent establishment definition…”[[125]](#endnote-126) The text of the 2017 OECD Model Tax Treaty[[126]](#endnote-127) included, as an addition to “habitually concluding contracts” the phrase “or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.”[[127]](#endnote-128) Changes to the Commentary also made it much easier for taxing authorities to treat a client’s or customer’s office as a permanent establishment for other enterprises.[[128]](#endnote-129) Taken together, these changes undercut the legal predicates of many traditional tax avoidance mechanisms; these changes make clear that arrangements that had previously isolated foreign companies from source taxation would no longer do so to the extent taxpayers were operating under a treaty incorporating these revised terms. Although the OECD’s Commentary makes clear that many of the changes were to be “prospective only and, as such, do not affect the interpretation of the former provisions of the OECD Model Tax Convention and of treaties in which these provisions are included,” it stated that others “were intended to clarify the interpretation of the Article and, as such, should be taken into account for the purposes of the interpretation and application of conventions concluded before their adoption….”[[129]](#endnote-130) Which particular changes fall in each category are unclear; at any rate, the United States “reserved its right to follow the versions of paragraphs 5 and 6 as they stood before the 2017 update of the Model Tax Convention.”[[130]](#endnote-131) Of course, the terms of U.S. tax treaties often have been of limited relevance to tax planning; what often matters is the terms of the tax treaty between the country in which the foreign operating company and the country in which the low-taxed F Sub is incorporated.

It takes time and effort to amend the terms of existing treaties even if the treaty partners are in agreement about the substance of proposed amendments to their joint agreement. Faced with concern that it might take decades for the treaty changes it advocated to be included in actual treaty documents, another part of the BEPS Action plan, Action 15, involved the development of an instrument, the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the “MLI”) to streamline the usually lengthy process of renegotiating treaties. The MLI allows signatories to agree in advance to specific modifications in treaty language drafted to conform with BEPS standards. Whenever both signatories to a particular bilateral treaty are also signatories of the MLI, their existing bilateral tax treaty is deemed to have been amended to those agreed-upon MLI terms. Signatories are allowed to pick and choose (in advance) the specific provisions they are willing to agree to;[[131]](#endnote-132) it is not an all-or-nothing decision. The MLI thus diminishes, if not eliminates the need for treaty-by-treaty, or term-by-term, renegotiations,[[132]](#endnote-133) speeding the implementation of “improved” tax treaties[[133]](#endnote-134) with their broad (or at least broader) definitions of “permanent establishments.” Approximately 100 countries are signatories to the MLI, but the United States is not among them.

Merely having a permanent establishment in a foreign country does not guarantee taxation by that foreign country, since tax treaties also limit countries’ ability to tax residents of their treaty partner to the income generated by and through that permanent establishment. Such income attributions are themselves often contested. Here again, U.S. multinationals relied on formal contractual agreements to justify their desired income allocations, and other countries sought to ignore them in an effort to increase taxation at source. These efforts are being aided by other elements of BEPS, Actions 8-10, which deal with transfer pricing. The DEMPE rules in particular were developed in an attempt to better align value with the activities actually carried out by entities.

### DEMPE

The factual predicate underlying many base-eroding structures was the right of low-taxed foreign entities to the returns engendered through the exploitation of intangible property and the assumption of business risks or the issuance of loans. As detailed earlier, those entities obtained these property rights through some combination of transfers of cash from related entities and cost sharing agreements. Some source countries began rebelling, refusing to assign tax consequences on the basis of bare legal ownership and pressing for transfer pricing rules that were more in line with their view of where and by whom value was created. They succeeded in including a new transfer pricing principle, based on the so-called “DEMPE” (for “development, enhancement, maintenance, protection, and exploitation of intangibles”) rules, as set forth in the OECD’s 2015 Transfer Pricing Report.[[134]](#endnote-135) Under these rules, income could only be assigned in line with “value creation.” What this meant in the IP context was that F Sub’s activities had to involve more than cost-sharing; its employees actually had to engage in the “development, enhancement or maintenance” of the value of the IP.[[135]](#endnote-136) To carry out DEMPE functions, of course, requires significant investment in operations for research and development—and thus U.S. firms have been further encouraged to build substance in non-U.S. jurisdictions.

More generally, as numerous commentators have remarked, “value creation” is a very ill-defined concept[[136]](#endnote-137) and in practice not only not very helpful but also likely to provoke disputes.[[137]](#endnote-138) Nor is its exact relationship to the preexisting arm’s-length standard clear. As a result, although some tax authorities claim to rely on DEMPE rules, others, including the United States, do not.[[138]](#endnote-139) It remains a source of aggravation for U.S. multinationals, though, precisely because of its lack of clarity and potentially vast scope.

### Transparency

The BEPS 1.0 Action items were not limited to devices for directly increasing the taxes paid by multinational taxpayers. Some of its most important recommendations had no immediate effect on tax liability; instead, they were aimed at making it easier for governments to identify tax avoidance in real time, enabling the development of future corrective measures. Action 12 called for countries to automatically forward summaries of certain previously confidential unilateral administrative tax rulings, such as decisions regarding arm’s-length pricing, to other countries,[[139]](#endnote-140) a mandate fulfilled (within the EU) by the EU’s adoption of Council Directive (EU) 2018/822.[[140]](#endnote-141) It also designed a system under which multinationals would submit annual reports detailing their profits, sales, employees, and taxable income on a country-by-country basis;[[141]](#endnote-142) over 100 countries (including the United States) have introduced this reporting obligation.[[142]](#endnote-143) Such transparency not only makes it more difficult for countries to hide their favoritism towards multinationals, but heightens the “audit, litigation, and reputational risks for multinational showing large profits in havens….”[[143]](#endnote-144)

## Unilateral Measures (Digital Services Taxes)

The traditional rules for the taxation of foreign taxpayers worked particularly poorly in the digital context. Countries were rarely able to tax profits generated from the sales of digital services to their residents because such sales could be carried out from any jurisdiction with internet access. In addition, the production of such services required little in the way of physical assets, making it easy to avoid creating a “permanent establishment” in high tax jurisdiction. A common generalization about companies operating in the digital space was that their highly profitable operations were (and are) highly mobile, enabling them to more easily take advantage of the structuring opportunities discussed in Part III.A, above, to achieve low foreign effective tax rates without suffering U.S. taxation under subpart F. Many practitioners and business leaders have challenged the notion that technology companies have minimal, easy-to-relocate operations and employee bases,[[144]](#endnote-145) or that the use of “mobile” intangible assets was unique to the digital economy,[[145]](#endnote-146) and BEPS 1.0 seemed to have its intended effect in driving multinationals to restructure their operations to conform with the DEMPE and substance-related requirements discussed above. Ultimately, however, political (as well as financial) pressures led many countries to enact “digital services taxes.”[[146]](#endnote-147)

The typical digital services tax is a gross receipts-based tax, imposed exclusively on certain companies in the digital services sector with revenues derived from online advertising services, receipts from digital intermediary activities, or sales of user-derived data.[[147]](#endnote-148) Taxpayers subject to such taxes owe a percentage of their gross receipts derived from revenue attributable to the country levying the tax, which in the case of at least advertising services and sales of user data is not necessarily the country of the customer. Digital services taxes are intended to fall outside the definition of an income tax, and thus escape from any tax treaty constraints.[[148]](#endnote-149) Whether that intention would be upheld is a matter of debate, since it can be argued that DSTs are taxes on “income or elements of income,” which could make them "covered taxes" under most tax treaties. Under pre-2022 regulations, the EU-style digital services tax might not have been creditable as a Code Sec. 903 “in lieu of tax” due to failing the substitution requirement.[[149]](#endnote-150) Thus their economic burden falls either on the foreign taxpayers or their customers.[[150]](#endnote-151) Preliminary evidence suggests that some of the burden has been falling on customers, rather than the digital companies, as intended.[[151]](#endnote-152)

The United States vigorously objected to the enactment of digital services taxes,[[152]](#endnote-153) but has been unable to convince countries to withdraw them. Threatened sanctions under Section 301 of the Trade Act may have created a deterrent influencing other states to not adopt a DST. The United States did reach agreement with some countries to agree to withdraw these digital services taxes once Pillar 1, Amount A, discussed in the next section, comes into force.[[153]](#endnote-154) It remains to be seen both whether that multinational scheme actually comes to fruition and what taxes beyond the original digital services taxes will be withdrawn as a condition of agreeing to Amount A. The most significant effect of digital services taxes may well be their effect on the United States’ attitude toward the Inclusive Framework that is the subject of the next section.[[154]](#endnote-155)

## “BEPS 2.0”—Inclusive Framework Pillar One

As the above discussion indicates, over the last decade many foreign governments have taken steps to increase the amount of source tax payable by F Subs, effectively increasing the multinational tax rate and cutting down on opportunities for tax minimization. At the outset of BEPS 1.0, the OECD stated that its focus was on ending double non-taxation while also preventing double taxation, acknowledging that companies were subject to a mix of source- and residence-based taxation and that the BEPS project did not purport to change the balance between them.[[155]](#endnote-156) But at the conclusion of BEPS 1.0, the OECD and its member nations determined that the changes wrought by the first phase of the project were insufficient to address the broader issue of taxing rights in the digital age.[[156]](#endnote-157) In June of 2021, the OECD established the Inclusive Framework aimed at further extending the scope and amount of source taxation. At present, the Inclusive Framework has 141 member nations, though several states still have not signed on to the two-pillar resolution.[[157]](#endnote-158)

The first part of BEPS 2.0, Pillar One, was originally aimed specifically at large digital enterprises and their ability to avoid taxation at source. However, in its latest incarnation, it applies to “all large and highly profitable groups”[[158]](#endnote-159) except those engaged in the financial services or extractive industries.[[159]](#endnote-160) It has two aspects. First, it provides that the “Covered Groups” will be deemed to have a tax nexus in any country in which they derive more than €1 million of revenue.[[160]](#endnote-161) It thereby dispenses with the requirement of a “permanent establishment” with its complicated physical presence and agency requirements altogether for those taxpayers. Pillar One also includes a mechanical rule for allocating income (“Amount A”) to these newly-empowered market jurisdictions. Under Pillar One, one-quarter of the profits earned by a Covered Group in excess of a 10 percent “profitability threshold” is assigned to market jurisdictions in proportion to their share of the Covered Group’s revenues.[[161]](#endnote-162) Since this income allocation is superimposed on top of the allocations determined in accordance with arm’s-length principles, the proposal contains elaborate rules for determining which entities and which jurisdictions will have their taxing claims reduced;[[162]](#endnote-163) the allocation to market jurisdictions is supposed to lead to a reallocation of taxing authority rather than duplicative taxation.

Although Amount A has received most of the attention, Pillar One also creates an “Amount B”— this transfer pricing measure is intended to apply broadly without reference to the revenue or profitability thresholds applicable to Amount A.[[163]](#endnote-164) Amount B would establish automatic returns for “baseline marketing and distributions activities” carried out in a jurisdiction.[[164]](#endnote-165) At least some commentators fear that Amount B will be used to allocate to limited risk distributors some of the returns to risk typically generated by nonresident principals, notwithstanding any contractual arrangement to the contrary.[[165]](#endnote-166) However, the specifics of Amount B, including the minimum (and maximum) rates of return for performing particular distribution and marketing tasks, remain unspecified.[[166]](#endnote-167)

There is considerable ongoing discussion regarding Amount A in particular. Although Pillar One authorizes market states to exercise taxing powers they were formerly precluded from exercising by operation of treaties (and in any event normally did not have authority to assert under their domestic law), it does not require by its terms that those powers be exercised. In tension with this is the fact that Pillar One requires a multilateral convention for its implementation. Countries are free not to legislate the novel nexus and profit attribution standards which would be authorized by Pillar One, though at least for countries without significant digital services tax taxpayers among their multinationals it is hard to see why they would want to give up the associated tax revenues. And there will be even less reason to do so if Pillar Two comes into play. As Pillar Two is, in form, closer to a residence-based tax (rather like GILTI), its discussion is deferred until the next section of this article.

# Enhanced residence taxation

There is no question that the effective rates of source taxation imposed on the F Subs of U.S. multinationals have increased in recent years due to the impact of the source tax reforms described in the last section, and they may increase more as some of the rules discussed above become more widely adopted and/or rigorously enforced. The success (or not) of such reforms will be disclosed by the mandatory country-by-country reporting regime. However, these reforms have not completely eliminated—at least as yet—the desire by some states for enhanced residence taxation. Even as the role of subpart F has declined, other tax regimes have risen to take its place. It remains to be seen whether these regimes can—or should—survive.

## GILTI

1. The Road to GILTI: The Tax Policy Study and Legislative Proposals

As discussed above, the progressive loosening of subpart F’s strictures and the increasing mobility of income enabled U.S. multinationals to accumulate profits from foreign operations in the “wrong” jurisdictions—i.e., low- and no-tax jurisdictions where the taxpayer had little or no real business activity. Taxpayers found that, to a large extent, subpart F was manageable enough and deferral was worth the hazards, especially considering the trade-off of repatriating foreign-earned income at 35 percent tax.[[167]](#endnote-168) In addition, falling tax rates around the globe and incentives to attract multinationals meant that, oftentimes, the low-tax jurisdictions were where the real business activities were located. Even if subpart F was working as intended, then, it was becoming less and less relevant. The Tax Policy Study analyzing the policy options available to Congress in 2000, the year it was written, admitted that “targeting related party transactions may no longer be an effective way to address tax disparity.”[[168]](#endnote-169) It concluded that “although the policies underlying subpart F may be as important (or more important) today as they were in 1962 (when subpart F was enacted), new developments are already challenging the effectiveness of subpart F, and these challenges seem likely to increase in the future.”[[169]](#endnote-170)

An important question addressed by the Tax Policy Study was whether this tax disparity mattered. Many perceived that the United States was losing out on meaningful jobs, investment and tax revenues as a result of the disparity between U.S. and foreign tax rates.[[170]](#endnote-171) Commentators frustrated with the inefficacy of anti-deferral policies suggested reforms to bridge the gap, including achieving full inclusion by treating all CFCs as pass-through entities.[[171]](#endnote-172) Yet others insisted that the U.S. needed to align with the majority of its trading partners and move to a territorial system of international taxation—that is, the U.S. should provide a participation exemption for earnings of foreign subsidiaries.[[172]](#endnote-173) Particularly as enhanced source taxation means that the multinational tax rate approaches the Indus tax rate (something that was not true at the time of the 2000 Treasury Study) this was, and remains, a question worth asking.

The Tax Policy Study was largely agnostic about this question, instead focusing on the plethora of options available to lawmakers once they decided on their tax policy goal(s). It evaluated several options for taxing foreign income, observing in a footnote that one option would be the adoption of a territorial system.[[173]](#endnote-174) The study focused on three main alternatives to counter erosion of the U.S. tax base. The first option was the repeal of deferral in favor of currently taxing all foreign income at the full U.S. rate. The second option, which actually consisted of several related options, would have entailed the current taxation of foreign income at a lower (but unspecified) tax rate. The amount of tax imposed could be computed on a CFC-by-CFC, qualified business unit (“QBU”)-by-QBU, or group-wide basis, and with or without foreign tax credits. The final option entailed a continuation of the subpart F regime but without the “foreign-to-foreign related party rules,” engendering current inclusion of foreign active income that fell below an effective foreign tax rate threshold.[[174]](#endnote-175) Again, the amount of the inclusion could be computed on a CFC-by-CFC, QBU-by-QBU, or group-wide basis. A sub-variant of this option would have required a U.S. shareholder to make an equalizing payment of tax to the United States to bring the effective tax rate on the foreign income up to a target rate after accounting for foreign tax credits. All three options retained the rule requiring current inclusion of passive income at full U.S. tax rates.

While not being explicitly described as such, the second and third options constituted “minimum taxes” on foreign income. The sub-variant of option three, requiring a payment of U.S. tax to top up the effective foreign tax rate to a target minimum rate, presaged the statute that became known as GILTI. Interestingly, the study acknowledged that retaining the subpart F architecture in the third option would thwart the goal of simplifying the international tax system.[[175]](#endnote-176)

It is important to understand the evolutionary path of U.S. international taxation in the years leading up to the 2017 Tax Cuts and Jobs Act to identify exactly what GILTI was meant to accomplish, and what was outside its scope. GILTI did not spring forth fully formed from legislators’ heads. It was the product of decades of deliberation on the global problem of base erosion and “harmful tax competition” and, in the United States in particular, on what to do about the “lockout effect” caused by the apparent unchecked deferral of foreign subsidiary income.[[176]](#endnote-177) This “lockout effect” was a problem created by the legislative compromise that undergirded subpart F. While subpart F accepted, and indeed blessed, U.S. multinationals’ ability to locate business operations offshore provided the earnings from those business operations were taxed in the “right” jurisdictions (i.e., the “natural business locus”),[[177]](#endnote-178) the income allowed to escape from immediate U.S. taxation under subpart F did not fully escape U.S. taxation. Any difference between the foreign taxes initially paid with respect to such income and the U.S. taxes payable with respect to such income became payable when and if this income was distributed by F Sub to its U.S. shareholder. Needless to say, most taxpayers were reluctant to make such distributions, causing foreign earned profits to pile up in F Subs, which could use the funds make further foreign investments—but not U.S. investments—free of this delayed tax obligation. As subpart F became ever more ineffective, an ever-greater number of dollars were thus “prevented” from being invested in the U.S. economy, where they could be used to create jobs for American workers.

The Obama administration took up the challenge to “reform” the international tax system early in its tenure. The first Obama Green Book, released in 2009, contained several significant proposals for international tax reform.[[178]](#endnote-179) While these proposals fell short of a full inclusion system, the proposals would have severely reduced the benefits of deferral.[[179]](#endnote-180) In 2010, Congress passed the Health Care and Education Reconciliation Act,[[180]](#endnote-181) which included some international provisions and, regarding CFCs specifically, the foreign tax credit splitter rules. But the bill did not include the provisions specifically aimed at deferral.

The Democrats’ loss of their Congressional majority following the 2010 mid-term Congressional elections stymied Obama’s tax policy goals for the remainder of his presidency. Nevertheless, the administration continued to refine its proposals in its subsequent budget proposals. During this period, Republicans Dave Camp (Ways & Means Committee chairman) and Michael Enzi (Senate Finance Committee), as well as Democrat Max Baucus (Senate Finance Committee) released their own international tax reform proposals. While it is not necessary to go into the details of all of these proposals, the overall contours of the ongoing tax policy debates reveal an emerging theme of a “minimum tax” on foreign income.[[181]](#endnote-182)

For example, Camp’s draft legislation in 2011 proposed three potential alternatives for addressing foreign income earned by U.S. multinationals, referred to as Options A, B and C. All three options incorporated the notion of a minimum tax and used subpart F mechanics to tax a U.S. shareholder on certain income earned at the CFC level. Option C contained a forerunner to what would become the preferential rate on domestically earned “foreign derived intangible income” (“FDII”).[[182]](#endnote-183) President Obama’s 2012 Framework for Business Tax Reform contained a similar minimum tax scheme, as did another proposal floated by Senator Enzi.[[183]](#endnote-184) The concept of a minimum tax on foreign income began trending heavily in policy proposals from that point on.

Harry Grubert and Rosanne Altshuler evaluated these legislative proposals in a seminal academic paper they authored in 2013.[[184]](#endnote-185) The authors optimistically claimed that “it is possible to make improvements to the system across many dimensions including the lockout effect, income shifting, the choice of location and complexity. The goals are not necessarily in conflict.” After comparing dividend exemption, full current inclusion, dividend exemption with an effective tax rate test subject to an exception for an active business (known as a “Japanese style” of dividend exemption, similar to Camp’s proposals), dividend exemption combined with a minimum tax (either country by country or overall minimum taxes), and repeal of check-the-box, they determined that the dividend exemption / minimum tax combination with expensing for “real investment” had many advantages over the other contenders. While a country-by-country minimum tax would yield the most precise results, the authors admitted that the relative simplicity of an overall “one-CFC” minimum tax merited serious consideration. The authors assumed a U.S. corporate tax rate of 30 percent and an effective minimum tax rate on foreign income of half of that, or 15 percent. One of the claimed advantages for a dividend exemption / minimum tax with expensing for investment was that this option presented some opportunities for simplifying the U.S. international tax system. Supposedly, foreign tax credit calculations for active income would “disappear.” Of course, a key underlying assumption was that there would be no allocation of the U.S. parent’s deductions to foreign income.

The Grubert and Altshuler study’s influence was apparent in subsequent policy proposals. Camp’s reprised draft legislation in 2014 revised his “Option C,” creating the new FBCII[[185]](#endnote-186) category of subpart F income and a new Code. Sec. 250 deduction for foreign intangible income, whether earned by a CFC or the U.S. parent, that would result in an effective U.S. rate of 15 percent. Notably, FBCII was computed by deducting 10 percent of the CFC’s “qualified business asset investment” or “QBAI” (essentially, basis in depreciable property used in a trade or business) and carved out the CFC’s applicable percentage of other subpart F income. However, the determination of FBCII and application of the effective rate under this proposal would have occurred at the CFC level, rather than on an aggregate basis. Starting with the 2016 fiscal year, the Obama proposal also adopted the “minimum tax” language, but this proposal called for the calculation of the minimum tax and foreign tax credits to be assessed on a per-country basis and it was framed as a “supplement” to the existing subpart F regime.[[186]](#endnote-187)

1. The Enactment of GILTI

It was from this primordial soup of competing minimum tax proposals that GILTI emerged. In 2017, Congress added the GILTI regime to the Code. While we typically think of GILTI as distinct from the subpart F regime, Code. Sec. 951A is in subpart F of the Code and in some ways functions as a special arm of subpart F. Like the subpart F regime, GILTI requires U.S. shareholders of CFCs to include currently their pro rata shares of certain income (in GILTI’s case, “tested income”) earned by those corporations. GILTI also relies on many of the core mechanical provisions of subpart F, including the definitional requirements for CFCs and U.S. shareholders, the deemed paid foreign tax credit rules under Code. Sec. 960, and the previously taxed E&P provisions of sections 959 and 961. There are certain key differences between subpart F and GILTI, however. First, unlike subpart F income, which is taxed at the full 21 percent corporate rate, GILTI is eligible for a 50 percent deduction under Code. Sec. 250 (through 2025) and therefore is generally taxed at an effective rate of 10.5 percent.[[187]](#endnote-188)

GILTI also departs from subpart F in its computation of income included under the regime. While subpart F targets specific items of income on a transactional basis, each CFC’s tested income starts with all of the CFC’s gross income, minus certain kick-outs, to arrive at a residual bucket of CFC gross income. Tested income does not include the CFC’s effectively connected income, subpart F income, income excluded from subpart F under the high-tax exception, dividends received from related corporations, or foreign oil and gas extraction income. At the CFC level, “properly allocable” deductions (determined under “rules similar to the rules of Code. Sec. 954(b)(5)”—another subpart F provision) are subtracted from the residual gross income to calculate the CFC’s tested income. If those properly allocable deductions exceed the CFC’s residual gross income, the CFC has a tested loss rather than tested income.

A significant feature distinguishing GILTI from subpart F is that the U.S. shareholder does not directly include its pro rata share of a CFC’s tested income as a deemed “dividend.” Instead, the tested income and tested loss of all of a U.S. shareholder’s CFCs are aggregated at the U.S. shareholder level to determine the U.S. shareholder’s “net CFC tested income.” That aggregated amount is then offset by the U.S. shareholder’s “net deemed tangible income return.” This amount is 10 percent of the U.S. shareholder’s aggregate pro rata share of its CFCs’ QBAI less certain interest expense. The result is the U.S. shareholder’s GILTI.

As under subpart F, U.S. shareholders that are domestic corporations may be entitled to a deemed paid foreign tax credit under Code. Sec. 960(d) to offset in whole or in part their GILTI tax obligations. The credit is available for foreign income taxes paid by CFCs that are “properly attributable” to tested income (tested foreign income taxes). However, the deemed paid foreign tax credits for GILTI are significantly limited compared to those available with a subpart F inclusion. First, a CFC that has a tested loss has no tested foreign income taxes. Thus, any foreign taxes paid by a tested loss CFC are lost in the ether. In addition, a U.S. shareholder is only deemed to have paid 80 percent of the “inclusion percentage” of the U.S. shareholder’s aggregate tested foreign income taxes. The “inclusion percentage” is the ratio of actual GILTI (that is, aggregate tested income less QBAI and tested losses) over the U.S. shareholder’s total tested income before taking QBAI and tested losses into account. U.S. shareholders benefiting from reductions in their GILTI inclusions due to QBAI and tested losses thereby lose the benefit of a proportionate amount of foreign tax credits. The inclusion percentage, combined with the 80 percent limitation, amounts to a “double haircut” on foreign tax credits available to offset GILTI. Added to these limitations, tested foreign income taxes are ineligible for any carryforward or carryback to different taxable years. Thus, GILTI foreign tax credits are subject to a strict “use them or lose them” regime. GILTI foreign tax credits are also segregated into their own separate Code. Sec. 904 limitation category.

GILTI mops up the income left over after application of subpart F and subjects that residual amount to current taxation, with limited foreign tax credits to alleviate the impact of this tax. As a result, subsequent distributions of this income do not have to be taxed, eliminating the “lock-out effect.” Code Sec. 245A’s participation exemption makes that clear. GILTI thus superficially resembles the “full inclusion” worldwide taxation regime that the Kennedy administration initially proposed in 1962. However, because of the Code Sec. 250 deduction, the tax imposed under the regime falls short of the normal U.S. tax. Moreover, GILTI does not in fact impose a tax on all non-subpart F income. The deemed return on QBAI falls neither within tested income nor subpart F, and due to Code Sec. 245A, is completely exempt from U.S. taxation. In short, rather than placing Acme and F Sub in the same position as Basic, GILTI imposes an incremental tax only with respect to U.S. shareholders whose CFCs’ income is taxed below a certain foreign tax rate. Specifically, the 50 percent deduction together with the 80 percent foreign tax credit targeted a “break even” overall (that is, across all CFCs) effective foreign rate of 13.125 percent. In short, GILTI is supposed to be a “minimum tax” ensuring that the income derived by F Subs is either subject to a foreign tax of at least 13.125 percent or a U.S. tax of 10.5 percent. The targeted foreign rate of 13.125 percent was equal to the effective domestic tax rate on FDII, which is entitled to its own deduction under Code. Sec. 250.[[188]](#endnote-189)

The rationale for imposing a minimum tax on foreign subsidiary income arose from the recognition that, by itself, a territorial system would provide too enticing an incentive to send value-creating capabilities outbound. Thus, further anti-base erosion backstops were required. As the 2017 Ways & Means Committee Report observed when introducing the “foreign high returns” rules (the precursor to GILTI), “[u]nder the participation exemption system provided for in the bill, however, foreign profits earned through a subsidiary generally will never be subject to U.S. taxation. Accordingly, new measures to protect against the erosion of the U.S. tax base are warranted.”[[189]](#endnote-190) The report cited the subpart F rules when acknowledging that “present law addresses transfers of property from a U.S. shareholder to its foreign subsidiary and subjects certain forms of passive or highly mobile income to current U.S. taxation.” But subpart F had proven inadequate to address the erosion of the U.S. tax base resulting from U.S. multinationals’ relocating assets and activities offshore. Ultimately, Congress enacted the Senate version of the current tax on GILTI as the way to address “the primary source of base erosion arising from a move toward a participation exemption system.”[[190]](#endnote-191)

## BEPS 2.0—Pillar Two

In form, Pillar Two (also referred to as the “Global Anti-Base Erosion” or “GloBE” rules) is an odd hybrid of residence- and source-based taxation, although it could be described as a residence-based minimum tax that grants primacy to, and actively encourages, taxation by source countries. It requires the jurisdiction of the ultimate parent of a covered multinational enterprise[[191]](#endnote-192) to impose a “top-up” minimum tax (denominated the “Income Inclusion Rule” or “IIR”) on the parent company’s proportionate share of any under-taxed foreign income derived by any constituent part of the enterprise sufficient to bring the tax on such income up to the 15 percent level. The IIR’s structural resemblance to GILTI as a parent-level minimum tax is no coincidence; shortly after the TCJA’s enactment, other countries began considering enacting similar minimum taxes, and the OECD quickly picked up the notion in Pillar Two.[[192]](#endnote-193)

Further, a second rule, the Undertaxed Profits Rule (“UTPR”) allows every country in which a U.S. multinational operates a secondary right to impose a top-up tax on any profits that are not already topped up under either a “qualified domestic minimum top-up tax” (“QDMTT”)[[193]](#endnote-194) imposed by a source country or an IIR. In this way, the GloBE rules give priority to taxation at source.

If a residence country fails to enact an IIR, the power to enact the tax passes to the jurisdiction(s) that are the countries of residence for the entities that are the next level down in the corporate chain.[[194]](#endnote-195) That is, if the parent company of a multinational entity (“MNE”) is a resident of Spain, with first level subsidiaries in the Netherlands and France, and Spain fails to enact an IIR, France or the Netherlands would have the right to impose an IIR on its corporation’s share of lower-tier subsidiaries’ undertaxed income. If no intermediate entity imposes an IIR, every other country in which the MNE operates may impose a top-up tax, provided those jurisdictions have enacted UTPR statutes. Countries imposing UTPRs apportion the revenue between them based on their share of employees and assets.[[195]](#endnote-196)

As long as some corporation in the MNE chain is a resident of a participating country, then, the IIR and the UTPR prevent the taxpayer from benefiting from operating in a country imposing taxes at less than a 15 percent effective rate. Given that participating countries will immediately claw back the difference between 15 percent and a lower tax rate, current low-tax countries are also deterred from maintaining their low-tax regimes and are instead encouraged to enact their own QDMTTs. After all, any taxes they forgo will be recouped by the MNE’s home jurisdiction (or another IIR or UTPR jurisdiction) rather than serving to attract inward investment. Better to collect the tax itself than allow another country to do so.[[196]](#endnote-197) The expectation is that the minimum tax will place a lower boundary on allowable tax competition. Indeed, the OECD specifically envisions that source countries may “introduce their own domestic minimum top-up tax based on the GloBE mechanics, which is then fully creditable against any liability under GloBE….”[[197]](#endnote-198)

The devil, of course, is always in the details. And there are many details. Most important is that the minimum tax rate is an effective tax rate, rather than a statutory tax rate. Neither source nor residence jurisdictions will be allowed to pretend to meet their minimum tax obligations by pairing a high statutory tax rate with a very restricted tax base. Pillar Two contains elaborate rules detailing the income base (based on financial statements) to be used when calculating the effective tax rate of a jurisdiction, as well as source rules for determining which income should be included in that base. Although a jurisdiction is free to enact base-reducing incentives, such as accelerated depreciation and research and development credits and the like, for calculating the tax due in its jurisdiction, many of those incentives will be ignored for purposes of calculating its effective tax rate for Pillar Two purposes, and if a taxpayer’s tax liability falls below the 15 percent minimum, it will find itself subject to a top-up-tax.[[198]](#endnote-199) In short, although a country may reduce its statutory tax rate of, say, 25 percent to an effective tax rate of 15 percent by offering taxpayers any number of tax incentives, if the effective rate of tax on the amount of income determined without reference to those incentives falls below 15 percent, the taxpayer will be deemed to be undertaxed and subject to a “top up” tax.[[199]](#endnote-200)

Just as importantly, the adequacy (or not) of the source tax will be determined on a jurisdiction-by-jurisdiction basis. There are no obvious possibilities for blending high-taxed (i.e. in excess of 15 percent) income with under-taxed income from another jurisdiction[[200]](#endnote-201) to bring them both up to the 15 percent level. The ordering rules impose limitations on the application of top-up taxes under a QDMTT, IIR or UTPR, however. In determining a constituent entity’s effective tax rate, the GloBE rules take into account its regular current tax expense (adjusted for certain items under deferred tax accounting principles), and, importantly, certain “covered taxes” are allocated from one constituent entity to another. These include taxes related to PEs, tax transparent entities, hybrid entities and taxes imposed by a “controlled foreign company tax regime.”[[201]](#endnote-202) Thus, tax imposed under a parent entity’s CFC regime—even if that CFC regime is not a “qualified IIR”—gets priority under the GloBE rules, as does a jurisdiction’s QDMTT.[[202]](#endnote-203)

Although 137 out of 141 countries have signed on to the Inclusive Framework’s two-pillar solution,[[203]](#endnote-204) it remains to be seen how many countries will actually enact the necessary domestic legislation and make the necessary tax treaty modifications to bring it into reality. Certainly the 2023 effective date envisioned by the OECD in 2021[[204]](#endnote-205) seems not only ambitious, but unrealistic.[[205]](#endnote-206) For example, Hungary recently blocked the EU’s attempt to adopt such laws,[[206]](#endnote-207) and in the United States, the Build Back Better Act (“BBBA”) containing (allegedly) conforming legislation never made it to the floor of the Senate. The Inflation Reduction Act, which was eventually enacted, did not contain any of the conforming provisions.[[207]](#endnote-208) At least some are already talking of its likely failure.[[208]](#endnote-209)

## Corporate Alternative Minimum Tax on Book Income

On August 16, 2022, the bill known as the “Inflation Reduction Act” (“IRA”) was signed into law.[[209]](#endnote-210) The IRA included a new corporate alternative minimum tax (“CAMT”). While there is little in the way of legislative history for the IRA, the CAMT was included among President Biden’s proposals in his Made in America Tax Plan. The Treasury Report presented the CAMT’s rationale thus:

To ensure that large, profitable companies pay a baseline amount of taxes, the President’s plan would impose a minimum tax on firms with large discrepancies between income reported to shareholders and that reported to the IRS. It would also provide the IRS with resources to pursue large corporations who do not meet their tax obligations, reversing a trend toward fewer corporate audits.[[210]](#endnote-211)

The CAMT requires a calculation of an “applicable” corporation’s tentative minimum tax, computed as 15 percent of such corporation’s adjusted financial statement income (“AFSI”) for the taxable year, less the CAMT foreign tax credit for the taxable year.[[211]](#endnote-212) To the extent that the tentative minimum tax exceeds its regular U.S. federal income tax liability plus its liability under Code. Sec. 59A for BEAT, the corporation has CAMT liability for the taxable year.

An “applicable corporation” is defined a corporation (other than an S corporation, a REIT, or a RIC) that has a three-year average annual AFSI (determined without reduction for financial statement NOLs) greater than $1 billion for at least one year prior to the current year.[[212]](#endnote-213) Average annual AFSI of a corporation generally includes all income of domestic corporations in a “controlled group” as defined under Code. Sec. 52 (i.e., the same definition as in Code. Sec. 1563(a), but substituting a 50 percent ownership threshold for 80 percent). There are special rules for foreign-parented multinational groups with domestic subsidiaries, with considerable authority delegated to Treasury to issue regulations. Importantly, applicable corporation status may cease if the corporation undergoes an ownership change or falls below the AFSI threshold for a certain number of consecutive years. Again, however, it is up to Treasury to determine how many years this will be, and the Secretary also must determine that it would be inappropriate to continue subjecting the corporation to the CAMT. Applicable corporation status resumes if the corporation meets the three-year average AFSI test for any tax year beginning after the year of the non-applicable corporation status determination.[[213]](#endnote-214)

Once a taxpayer is an applicable corporation, the taxpayer’s AFSI for the taxable year must be determined. AFSI means net income or loss of the taxpayer set forth on the taxpayer’s “applicable financial statement” (e.g., a Form 10-K)[[214]](#endnote-215) for a given year, adjusted as provided in new Code. Sec. 56A. The statute generally provides for a number of adjustments among related parties, although just about all of these require additional input from Treasury.[[215]](#endnote-216) With respect to foreign income, the taxpayer must include its pro rata shares (determined under rules similar to Code. Sec. 951(a)(2)) of items taken into account on the applicable financial statement of each CFC of which the taxpayer is a U.S. shareholder. These items must be adjusted under rules similar those that apply to determine AFSI. The included pro rata share cannot fall below zero. Rather, negative adjustments are carried forward to the succeeding year, at which point they can reduce pro rata income shares.[[216]](#endnote-217) AFSI disregards any federal income taxes and is likewise adjusted upwards for foreign taxes that are taken into account on the applicable financial statements. The Secretary may waive this adjustment where the taxpayer deducts and does not credit the taxes. There are a number of other AFSI adjustments for depreciation, NOLs and elections for certain credits.[[217]](#endnote-218)

After AFSI is determined under Code. Sec. 56A, the remaining item in the Code. Sec. 55(b)(2) tentative minimum tax equation is the CAMT foreign tax credit. The CAMT foreign tax credit is determined by determining two quantities and adding them together.[[218]](#endnote-219) Quantity 1 is the *lesser* of: (a) the aggregate of an applicable corporation’s pro rata share (determined under rules similar to the rules under Code. Sec. 951(a)(2)) of the foreign income taxes that are taken into account in the applicable financial statement of, and paid or accrued for federal income tax purposes by, each CFC with respect to which the corporation is a U.S. shareholder; or (b) 15 percent of the aggregate of the applicable corporation’s pro rata share of the adjusted AFSI (determined under rules similar to the rules under Code. Sec. 951(a)(2)) of the CFCs with respect to which the corporation is a U.S. shareholder. Quantity 2 is Code. Sec. 901 taxes taken into account on a domestic corporation’s applicable financial statement and paid or accrued for federal income tax purposes. Quantity 1 plus Quantity 2 is the CAMT foreign tax credit, which gets subtracted from 15 percent of AFSI to determine the tentative minimum tax amount for the taxable year.

The “lesser of” comparison above means that there is a 15 percent limitation on Code. Sec. 960 deemed-paid foreign tax credits for CFC income, but there is no such limitation on direct foreign tax credits at the U.S. shareholder level. This is the only limitation preventing cross-crediting of foreign tax credits for CAMT purposes, as the Code. Sec. 904 limitation does not apply. Thus, even if the taxpayer is otherwise in an excess credit position, those credits that do not reduce regular taxable income are nevertheless available to reduce the corporation’s tentative minimum tax. To the extent the taxpayer’s actual share of CFC foreign taxes exceeds the 15 percent limitation, that amount carries forward for five years and increases the taxpayer’s actual share of CFC foreign taxes for each of those subsequent years unless or until used in computing the tentative minimum tax.

Once the tentative minimum tax is determined, that amount is compared against the sum of the taxpayer’s regular tax liability and tax liability under BEAT.[[219]](#endnote-220) The CAMT increases a taxpayer’s tax only to the extent that the tentative minimum tax exceeds this amount. Even if a taxpayer has incremental CAMT liability for a given taxable year, under Code. Sec. 53 the taxpayer gets a CAMT credit that it can carry forward indefinitely. Thus, to the extent a taxpayer’s regular tax liability exceeds its AMT liability in future years, AMT that the taxpayer pays in prior years can reduce that regular tax liability.

# The Way Forward?

The rules for the taxation of transnational income are clearly undergoing a “seismic shift.”[[220]](#endnote-221) The resurgence of source taxation has already raised effective tax rates on the most undertaxed income and reduced the value of traditional tax planning mechanisms. If Pillar Two is successfully implemented, additional source country taxation is likely forthcoming—ironically as the result of the IIR, a residence-based mechanism, and the UTPR, which may be applied to impose tax without any taxing jurisdiction at all. Indeed, additional source country taxation seems inevitable at the level of individual countries, even if the collective Pillar Two project ultimately stalls out. The question is how the United States, as the home to the world’s most profitable multinationals, should react to this new reality.[[221]](#endnote-222) To answer this question requires revisiting the fundamental policy decision that underlay subpart F. Should the goal be to ensure that all the income of U.S. multinationals be taxable at the domestic tax rate (i.e., should the goal be to equalize the tax treatment of Basic and Acme) or should it be to equalize the tax treatment of Acme’s foreign income with that of Nederland and Indus? The answer need not be the same for all types of income; subpart F itself treated both passive income and income generated from traditionally problematic sectors of the economy (insurance and shipping) differently from other foreign business income.

As laid out at the beginning of the paper, there is no clear right answer to this question. Policy arguments can (and have) been made for both outcomes when one is dealing with the taxation of foreign business income.[[222]](#endnote-223) The case for what amounts to capital import neutrality (or capital ownership neutrality) of such income is most convincing when a low foreign tax rate is attributable to the paucity of government services, services that an F Sub may have to pay for out of its own pocket.[[223]](#endnote-224) But it is unclear why the United States should feel the need to dictate—or punish its multinationals for its failure to be able to dictate—developed countries’ revenue raising choices. Surely countries should be able to choose a different mix of corporate income taxation and value-added taxation, for example, particularly if the choices are constrained by the Pillar Two minimum tax. And colonialism/overstepping bounds works in both directions inasmuch as U.S. tax policy, for better or for worse, is often impacted by the tax choices made by other nations. From the outside, it may be impossible to tell which country’s tax policy is more “imperialist.”

Tax philosophy aside, the underlying economics are also uncertain. Is the United States’ economy better off if Acme can compete on equal terms with Nederland, which may lead to more foreign (rather than domestic) investment, or if Acme is placed on a tax par with Basic? Will Basic gain from obtaining a level tax playing field with Acme, or will they both end up being disadvantaged relative to a more successful Nederland? And to what extent will businesses react by incorporating or reincorporating as foreign rather than domestic corporations?[[224]](#endnote-225)

Finally, it is worth noting that it is unclear how significant the choice between the two alternatives will be if Pillar Two is widely adopted. Pillar Two strongly encourages (some would say coerces) source countries to impose a 15 percent minimum tax, calculated with respect to a broadly defined tax base. At present, the U.S. corporate tax rate is 21 percent, calculated with respect to a tax base that contains many exemptions and incentive provisions. The value of those exemptions and incentives differ from taxpayer to taxpayer, but it would not be terribly surprising to find that for many taxpayers, there is little difference between the 15 percent minimum tax calculated under the Pillar Two rules and a 21 percent U.S. tax obligation calculated on the regular corporate tax base.[[225]](#endnote-226) Obviously the stakes would go up if the U.S. corporate tax rate increased, as some have proposed (in that a higher domestic rate presumably would make the 15 percent Pillar Two rate more attractive), but it is unclear when or if that will happen.

What is clear, however, is that it is ridiculous to have three overlapping minimum tax regimes on foreign income calculated with respect to slightly different bases (GILTI, CAMT, and, if widely-implemented, Pillar Two), plus a fourth CFC regime (subpart F) whose complicated rules continue to take up a great deal of taxpayers’ (and their advisors’) time, even as it accomplishes little in the way of policing base erosion. The result is extraordinary complexity, with little thought as to whether such complexity generates any policy gains. The way forward ideally would involve some simplification effected by unifying these overlapping regimes into a single, more coherent structure.

The seemingly inexorable growth of our tax law suggests that repealing and clarifying laws is much more difficult than adding new ones. However, there is (relatively) recent precedent for this type of brush clearing in the case of transnational taxes specifically. Some will remember that back in 1993, former Ways and Means Committee Chairman Dan Rostenkowski outlined a possible reduction, rationalization and harmonization of the U.S. anti-deferral regimes.[[226]](#endnote-227) Although the specific proposal was not enacted, the reform sentiment led, in the Taxpayer Relief Act of 1997 and the American Jobs Creation Act in 2004, to: (i) the repeal of the foreign personal holding company regime; (ii) the repeal of the foreign investment company regime; and (iii) the repeal of the so-called CFC / passive foreign investment corporation (“PFIC”) overlap.[[227]](#endnote-228) We advocate for a similar rationalization here.

The three minimum tax regimes can and should be condensed into one, or at most two (with the second applicable to passive income and perhaps specifically disfavored industries) which, unlike the current minimum tax regimes, are well thought-out and internally consistent. For optimal simplicity, unlike the current configuration, the combined regime would meet the requirements of a Pillar Two IIR and QDMTT if so desired. Subpart F’s role should be scaled to serve primarily as an anti-abuse provision directed as passive income and particularly disfavored industries. We discuss the minimum tax on active foreign income first, and the fate of subpart F second.

## Minimum Tax on Active Foreign Income

The U.S. international tax system has been described as a system without a guiding principle.[[228]](#endnote-229) In some ways, global convergence around some form of consensus has externally supplied a framework, if not that elusive principle, that can form the basis of U.S. international tax policy’s next phase. Assuming the Inclusive Framework adopts the Pillar Two GloBE rules[[229]](#endnote-230) and the United States does not conform GILTI to Pillar Two requirements, there will be three minimum taxes applicable to the foreign income derived from business activities by U.S. multinationals: the 15 percent CAMT on book income, GILTI (currently designed to require a purported 13.125 percent minimum foreign effective tax rate), and the tax imposed under the GloBE rules (either by application of an IIR or a UTPR). In service of creating a rational and streamlined system for U.S. taxpayers, the goal should be for only one minimum tax regime to apply to CFCs.

Of the three, the newly enacted minimum tax on book income is probably the least helpful in a post-Pillar Two world. Not only do its revenue threshold and computational base diverge from those of Pillar Two,[[230]](#endnote-231) the CAMT computes the tentative minimum tax on an aggregate worldwide tax basis, as opposed to determining the tax on a jurisdiction-by-jurisdiction basis. Thus, it permits cross-crediting among CFCs because it computes a taxpayers’ effective tax rate by looking at the taxpayer’s worldwide income and foreign tax obligations, so that a taxpayer paying a higher-than-15 percent tax on some items of foreign income can use those excess taxes to offset income subject to tax elsewhere at a less-than-15 percent rate.[[231]](#endnote-232) In this respect, the CAMT should not be a qualified IIR for Pillar Two purposes.[[232]](#endnote-233)

The CAMT’s cross-crediting aspect is interesting. While a U.S. shareholder’s CAMT foreign tax credit with respect to foreign taxes imposed on its CFCs is limited to 15 percent of its pro rata share of aggregate CFC AFSI, the CAMT does allow for blending of high- and low-taxed income, not only between items of foreign income but between foreign and domestic income. In this way, the CAMT resembles GILTI somewhat, but it is even more permissive in terms of cross-crediting, as the income and foreign taxes are not segregated into limitation categories under Code. Sec. 904. If anything, taxpayers are encouraged to earn income in low-tax foreign jurisdictions, provided they have high-enough-taxed income in the United States. This indicates that the CAMT is not really intended as an anti-base erosion measure. Rather, it takes a snapshot of the entire taxpayer group and asks whether, on an overall basis, the taxpayer has paid 15 percent on its book income. This ostensibly neutralizes arbitrage opportunities arising from book-tax differences (i.e., minimizing income for tax purposes but maximizing income for financial statement purposes). Given the way the CAMT deals with temporary differences and provides a CAMT credit to use against excess tax paid on book income in future years, however, the CAMT may only amount to a timing issue for many taxpayers, when those taxpayers will be subject to regular income tax at a higher rate in future years.[[233]](#endnote-234) To be sure, the CAMT rules could be tinkered with to bring the tax more in line with a qualified IIR for Pillar Two purposes (i.e., measuring the top-up and allowing foreign tax credits on a jurisdiction-by-jurisdiction basis, revising the AFSI computational base to align with the requirements in the GloBE rules, etc.). But to do so would, effectively, create a parallel, and administratively duplicative, country-by-country GILTI regime that happens to include the U.S. base. GILTI is already several steps closer to a qualified IIR (and we even have the draft legislation to get us there). Thus, it would be simpler to enact a conforming Pillar Two tax, and eliminate the CAMT altogether.

Indeed, the CAMT as currently drafted seems aimed at least as much at ensuring that corporations pay a minimum amount of tax on their domestic income as on their foreign income. A corporation can avoid paying CAMT on untaxed foreign income if the tax paid on its domestic income is high enough. There is no requirement that either subset of income be subject to tax at a 15 percent minimum rate. While the goal of taxing domestic income may have merit (and indeed might be necessary to protect U.S. source tax revenues even in a Pillar Two world), it would be better accomplished by having a separate minimum tax applicable only to U.S. source income, which complied with the QDMTT requirements under Pillar Two.[[234]](#endnote-235) Such a separate tax would not duplicate the computational effort of a minimum tax on foreign income, would prevent the opportunity to blend effective tax rates applicable to U.S. and foreign income and would enable the United States to collect all the tax to which it is not only entitled, but which would otherwise be redirected to other countries’ treasuries under their UTPRs.

Even if policymakers determine that there is enough reason to retain the CAMT as a backstop against book-tax difference exploitation, however, any tax imposed under the CAMT as-is could be viewed as a “covered tax” imposed under a CFC tax regime for Pillar Two purposes. This would give CAMT liability priority in the ordering rules before any top-up tax is assessed under an IIR or a UTPR. The same should be true of GILTI, if it is not revised to be a qualified IIR that applies on a country-by-country basis, and of subpart F. The difficulty lies in determining how much of a U.S. taxpayer’s CAMT, GILTI or subpart F liability is traceable to a particular jurisdiction as a “covered tax,” particularly in light of the cross-crediting each regime allows. While complicated, it is, however, possible to devise rules for allocating the ultimate (i.e., net of foreign tax credits) U.S. tax liability under CAMT, GILTI or subpart F back to each CFC. Thus, if the United States chooses not to go along with Pillar Two, and maintains the aggregation and cross-crediting of its various foreign income taxation regimes, the U.S. tax imposed under those regimes should blunt the impact of other jurisdictions’ IIRs and UTPRs.

Then there is GILTI. The legislative history to Code. Sec. 951A, as well as the lively policy debate in the run-up to 2017, clearly established that GILTI was intended to function as a minimum tax. If a CFC’s foreign effective tax rate goes below the GILTI floor, the United States tops up the tax. It is the mechanism by which Congress has drawn the line between acceptable tax competition and what amounts to harmful use of tax havens. Where that line ends up depends on the amount of the Code. Sec. 250 deduction and is, ultimately, a political question.[[235]](#endnote-236) But a U.S. multinational that pays an average effective foreign tax rate above that floor with respect to its GILTI should not be subject to any incremental U.S. tax.

In theory, a foreign tax rate of 13.125 percent should eliminate any U.S. tax liability on GILTI. The conference report stated that “as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent. At foreign tax rates greater than or equal to 13.125 percent, there is *no residual U.S. tax owed on GILTI*, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.”[[236]](#endnote-237)

As every U.S. multinational knows, however, the reality of how the GILTI “minimum tax” plays out in the complex foreign tax credit system is quite different. There are a number of instances in which taxpayers facing foreign tax rate higher than 13.125 percent—indeed, infinitely higher—end up also bearing a residual U.S. tax liability. These situations can be traced to strange interactions between GILTI’s Code. Sec. 904 tax credit limitations, various deduction limitations, and the absence of credit carryforwards and carrybacks for foreign taxes in the GILTI basket. The Appendix to this article walks through several highly simplified examples below to illustrate how this happens.[[237]](#endnote-238) These examples make clear that, because of the mechanics of Code. Sec. 904, GILTI does *not* work as a minimum tax should, or at least does not work as Congress said this tax would. Because the foreign tax credit is so central to GILTI’s ability to function as a minimum tax (indeed, the foreign tax credit *is* the way GILTI operates as a minimum tax), a broken Code. Sec. 904 limitation system means the minimum tax, itself, is broken. In an ironic twist, subpart F income has become an attractive alternative for taxpayers whose GILTI basket foreign tax credit problems are bad enough—the 21 percent rate means the tax rates in foreign jurisdictions are now more likely to “pay for” inclusion at full U.S. tax, and subpart F inclusions in the general basket get carryforwards and carrybacks.[[238]](#endnote-239)

These defects could be remedied by removing GILTI from the Code. Sec. 904 framework and calculating it as a standalone minimum tax. The problems were noted immediately after the TCJA was signed into law.[[239]](#endnote-240) There was little that Treasury could do to rectify the situation on its own authority, given Congress’s designation of a GILTI basket in Code. Sec. 904(d)(1)(A).[[240]](#endnote-241) Treasury did what it could; it granted exempt asset status to the extent of the Code. Sec. 250 deduction for purposes of expense allocation and apportionment. But Treasury could not and cannot write Code. Sec. 904(d)(1)(A) out of the Code. Legislative action will be necessary to take Code. Sec. 951A out of the Code. Sec. 904 scheme.

Recent proposed legislation indicates that Congress is aware of the issues plaguing GILTI. In addition to applying Code. Sec. 904 on a country-by-country basis,[[241]](#endnote-242) the BBBA bill the House of Representatives passed in November 2021 contained changes to Code. Sec. 904 that would limit the U.S. deductions allocated and apportioned to the GILTI basket to the Code. Sec. 250 deduction, taxes deductible against GILTI and any other deduction that the Secretary determines is directly allocable to GILTI.[[242]](#endnote-243) Those deductions that the Secretary determines are not directly allocable to GILTI would instead be allocated or apportioned only to U.S. source income. The effects of the OFL and SLL rules on the GILTI basket likewise would be eased somewhat.[[243]](#endnote-244) The ODL rules, however, would apply as they do under current law.[[244]](#endnote-245)

Unfortunately, the BBBA did not produce a record with legislative history to shed light on the reasoning behind the proposed changes. Many have speculated that the House bill only included these modifications to the application of Code. Sec. 904 to GILTI because the bill also included Code. Sec. 163(n). This provision would limit deductions for interest expense based on the ratio of the leverage of the “international financial reporting group” over the leverage of the domestic corporation—thus effectively measuring whether the domestic group is over-leveraged compared to the international group. The rationale tying the modification to Code. Sec. 904 to Code. Sec. 163(n) could be that it is logical not to allocate a domestic corporation’s interest expense deductions to income earned by the CFC of a domestic corporation (and included in the income of the domestic corporation) if “excess” interest deductions of the domestic corporation (i.e., those deductions in excess of its own share of interest expense of the international financial reporting group) have already been denied altogether. But this rationale would not readily explain why the BBBA did not contain a similar mechanism to take into account subpart F income. Therefore, it is possible that lawmakers had been made to understand that Code. Sec. 904 was not working with respect to the GILTI basket in particular. In any case, the provisions in the House bill arguably did not go far enough to remediate GILTI’s Code. Sec. 904 ills.

The recently enacted CAMT, while not a good candidate for a minimum tax that “does it all,” presents a model for how to greatly simplify the foreign tax credit mechanism for a minimum tax. For purposes of calculating the tentative minimum tax, the CAMT allows a foreign tax credit without any imposition of basket-by-basket limitations. Rather, all CFC-related inclusions of subpart F income and GILTI are accounted for at the U.S. shareholder level, and a credit is allowed for the lesser of: (1) all of the foreign income taxes taken into account on the applicable financial statement of each CFC, or (2) 15 percent of all CFCs’ AFSI. Thus, with no mention of Code. Sec. 904, the CAMT foreign tax credit for CFC-level foreign taxes is limited to a fixed minimum effective foreign tax rate (15 percent). The GILTI minimum effective foreign tax rate would float with whatever the Code. Sec. 250 deduction happens to be, but could similarly limit the foreign tax credit to the desired minimum effective foreign tax rate (currently 13.125 percent). Excluding Code. Sec. 951A from Code. Sec. 904 would eliminate the complexities of allocating and apportioning deductions and maintaining OFL, SLL and ODL accounts for the GILTI basket. This becomes even more helpful in the event that the United States does adapt GILTI to comply with the Pillar Two qualified IIR requirements. If GILTI were amended to apply on a country-by-country basis, keeping the application of Code. Sec. 904 as-is would require separate allocation and apportionment of deductions and maintenance of separate OFL, SLL and ODL accounts for each *country*-level GILTI basket. The administrative burden of such a proposal is staggering and the prospect no doubt fills both taxpayers and the IRS with dread. Thus, taking GILTI out of Code. Sec. 904 would likewise greatly simplify determining whether the minimum tax threshold is met, even on a country-by-country basis.

Such legislative action could be combined with the other changes needed to make the GILTI regime compliant with Pillar Two, such as establishing a minimum tax rate of 15 percent (by adjusting the amount of the Code. Sec. 250 deduction), applying the minimum tax and foreign tax credit calculations on a jurisdiction-by-jurisdiction basis, and (perhaps) aligning the tax base more closely with the GloBE rules. Alternatively, GILTI could be replaced in its entirety by a potentially simpler Pillar Two compliant step-up tax. That is, instead of painstakingly amending the GILTI rules to make them complaint with Pillar Two, a new regime could be designed from scratch which might lack some of the complexities of an amended GILTI without substantially changing its economic effect. An explicit and somewhat simplified Pillar Two compliant step-up tax, after all, would achieve the stated aims of the GILTI regime, with the exception of the exclusion from U.S. taxation of the deemed tangible income return—an exclusion which would violate Pillar Two in the absence of a higher tax rate levied on other income. However, there is no assurance that a Pillar Two-specific minimum tax based on the GloBE model rules would be any simpler than GILTI, a regime with which taxpayers have spent the last five years growing, if not comfortable, at least familiar.

Indeed, even if the Inclusive Framework crumbles, it might make sense to adopt a single minimum tax for business income generated through foreign activities. As Grubert and Altshuler suggested in their study, a country-by-country minimum tax would yield more precise results and would foreclose taxpayers’ ability to cross-credit high- and low-tax income. As mentioned, a country-by-country minimum tax could relatively easily (without disruption to the rest of the international tax system) be adjusted to target the tax rate Congress deems desirable. Having a single tax, calculated with respect to a single tax base, rather than multiple taxes calculated with respect to multiple different tax bases, none of which has been singled out as particularly meritorious, would reduce compliance costs without undercutting Congressional intent. If taxpayers are subject to only one CFC regime on active income, and that regime operates as a true, streamlined minimum tax, it would make country-by-country application of that regime easier to swallow. But we should keep in mind the Grubert and Altshuler study’s pragmatic conclusion that a minimum tax that applies on an aggregate basis has much to recommend it for its comparative simplicity.

Finally, there is subpart F. If U.S. multinationals are subject to a true minimum tax on foreign business income, it is questionable whether subpart F adds any value with respect to active income of CFCs. But subpart F’s coverage was never limited to foreign business income. It also applied to passive income and income generated in the context of problematic activities.[[245]](#endnote-246) The question of what should be done with the remainder of subpart F is the subject of the next section of this Article.

## Passive Income and Beyond

Subpart F still takes precedence over GILTI, and U.S. multinationals must arrange their offshore operations carefully to prevent its application. As discussed at length in Part III, however, subpart F acts mostly as a planning hurdle and a trap for the unwary. Congress seems to have abandoned the use of related-party transactions to police foreign-to-foreign base erosion, and with the global movement to shut down abusive structures and enforce a minimum level of source taxation, the opportunities for foreign-to-foreign base erosion have dwindled. The moment seems ripe for slimming subpart F down to a regime better suited to its remaining purpose—provided, of course, that we can agree on what that purpose is.

The United States is a source country, as well as a residence country, and is justifiably concerned about ensuring that it collects the taxes due on income earned within its borders, whether that income is earned by U.S. entities (Basic), U.S. multinationals (Acme), or foreign-owned multinational entities (Nederland). Although some countries are happy to use lower-than-normal tax rates to attract mobile foreign capital, the United States has often refused to do so—if only due to the fear that such tax benefits may entice U.S. taxpayers and entities to reinvent themselves as foreign entities to garner those tax benefits. Basic, Acme and Nederland are all supposed to pay the normally applicable U.S. tax rate on income derived from U.S. business operations. More generally, Congress may desire to continue to impose a heavier tax burden—one keyed to full U.S. tax rates rather than the 15 percent minimum tax rate—on passive income as well as income generated from objectionable activities or in objectionable jurisdictions.[[246]](#endnote-247) As noted earlier, there is less reason to worry about Acme’s competitive position vis-à-vis Nederland when the income at issue is passive in nature, and more reason to worry about the potential for foreign financial institutions to undercut domestic institutions in attracting passive investment capital.

Nor is there any reason to think that Congress is interested in reducing the sting of the various penalty regimes that are effectuated through the subpart F regime.[[247]](#endnote-248) Subpart F could be retained as a narrowly targeted provision aimed at taxing only at those items of income at the full U.S. rate, even if Congress decides that the approach it adopted in 2006 for active foreign business income under Code Sec. 954(c)(6) remains the correct one for those activities and that income. Alternatively, the scope of the PFIC regime could be broadened to encompass at least some of these income items (particularly the passive income), following the pattern established when it merged the foreign personal holding company regime into the PFIC. It is unclear, however, whether such a merged regime would in fact be simpler for either the IRS or taxpayers to deal with than the continued maintenance of the existing (but much reduced) subpart F regime, particularly if some version of subpart F has to remain to deal with targeted industries such as insurance and the various penalty regimes.

With the potential onset of the Pillar Two GloBE rules, Congress has already begun reimagining subpart F. The first iteration of the BBBA, which the House of Representatives Ways & Means Committee released in September 2021, retained foreign personal holding company income and the high-tax exception, but revised the foreign base company sales and services income rules such that “the term ‘related person’ shall not include any person unless such person is a taxable unit (within the meaning of section 904(e)) which is a tax resident of the United States.”[[248]](#endnote-249) The provision also granted Treasury authority to issue regulations covering “a series of transactions” in which a U.S. tax resident is a party and repealed the manufacturing and sales branch rule. In November 2021, the House of Representatives passed a BBBA bill that included similar changes to limit foreign base company sales and services income to transactions or series of transactions involving a U.S. party, but with certain elaborations, including a grant of regulatory authority to treat a branch as a CFC “whether tax resident or located inside or outside the country in which the controlled foreign corporation is a tax resident.”[[249]](#endnote-250)

The gist of these proposals was that Congress was prepared to give up entirely on subpart F provisions that purport to address foreign-to-foreign base erosion. Leaving in foreign base company sales and services rules that catch supply chains involving U.S. participants indicates that the United States still thinks subpart F can play a useful role in policing CFC transactions that erode the U.S. base directly (e.g., through “round-tripping” transactions whereby CFCs sell to the U.S.). However, it is questionable whether these anti-round-tripping provisions are even worth keeping. Subpart F would retain the exceptions for CFC manufacturing activity and same-country services, and check-the-box remains on the books as well. Putting aside what the inchoate Treasury-devised branch rule might look like (no one knows), it seems unlikely that the foreign base company sales and services rules would reach many transactional structures, even if a U.S. taxpayer is a party. In addition, the shrinking rate differential between the U.S. corporate income tax rate and the GILTI minimum effective tax rate (assuming it goes up to 15 percent), as well as relatively high (and ever-increasing) tax rates imposed at source, compound the futility of trying to maintain the complicated foreign base company sales and services rules.[[250]](#endnote-251) For similar reasons, Congress should make Code Sec. 954(c)(6) permanent, thus eradicating the “foreign-to-foreign related party rules” as suggested in Treasury’s Tax Policy Study.[[251]](#endnote-252) It is also worth noting that if the goal is to equalize the tax treatment of Acme and Nederland with respect to income earned in the United States, subpart F by itself is unable to do so as it does not apply to income derived by foreign multinationals. Such equality can only be obtained by limiting Nederland’s ability to recharacterize U.S. business income as treaty-protected income by limiting the deductions allowed to be claimed by the U.S. operating entity. The solution, in short, is the BEAT, Code Sec. 59A, or some new and improved version of the BEAT, not a new and improved version of subpart F.

Ultimately, Congress should do away with the foreign base company sales and services rules and scale back subpart F significantly to apply narrowly to passive income, thereby addressing the old “incorporated pocketbook” concerns, and to function as a targeted and well-defined anti-avoidance regime for any particular industries or other transactions that Congress finds problematic. In such an environment, a simplified GILTI that is freed from the awkward and cumbersome foreign tax credit limitation rules would function as the United States’ primary anti-base erosion regime. It seems plausible that many U.S. multinationals would even accept paying a somewhat higher rate on GILTI if the trade was getting rid of subpart F and amending GILTI’s tax credit rules so that the effects of the regime matched is description in the legislative record.

# Conclusion

There has been fairly widespread agreement that the rules for the taxation of international transactions were unnecessarily complex, to the point of being unadministrable, even before the addition of the CAMT and the (possible) advent of Pillar Two. Complexity has been layered on top of complexity, with little or no thought as to how the various “improvements” actually interact with previous reform schemes. A serious reorganization and consolidation of these rules is long overdue. One cannot undertake this, however, without first confronting the elephant in the room—what the underlying tax policy goal ought to be. Should Acme always pay the same tax as Basic, even when it is not (by definition) competing with Basic, or should it be allowed to compete on equal tax terms with Nederland and Indus? Or should the baby be split, and Acme be allowed to pay tax at a rate somewhere in between the U.S. rate and the Nederland rate? Reasonable people have and continue to disagree on this question, but it is nonsensical to think that continued waffling over this basic policy decision helps anything—or that the policy dilemma can be resolved by increasing the complexity of the rules for taxation of transnational income to such an extent that no one can tell what policy choice has been made. The surge of source taxation and successful implementation of Pillar Two will largely eliminate (and certainly ameliorate) the difference between these three alternatives, assuming current tax rates. But of course, tax rates can change (and given current government budget deficits such change seems likely). A minimum tax such as GILTI or a Pillar Two-type tax can handle such a change (the minimum tax rate can be higher than 15 percent) but only at the cost of upsetting the equilibrium between Acme and Nederland.

Subpart F, in its original incarnation, allowed Acme to compete with Nederland, as long as it was not operating through artificial structures that allowed it to undercut the Indus tax rate. In its current incarnation, and the current economic environment, subpart F is powerless to stop a U.S. multinational from enjoying the multinational tax rate (though that rate is less accessible due to changes in source taxation). It is left playing only a residual role, taxing only certain categories of passive income and combatting a few methods of stripping income from transactions that “strip” U.S. business operations.

And what if the Inclusive Framework falls apart? What if enough source countries refuse to impose a tax that will discourage foreign investment, and enough residence countries refuse to impose a step-up GloBE tax? Would a reformed subpart F then become more desirable? The answer will turn on whether it is possible to tax Acme at rates higher than Nederland without triggering, if not an exodus of U.S. multinationals, the loss of all future multinationals. How much market power does (and will) the U.S. have as a residence country? Forty years ago, Gary Hufbauer thought that the answer was “not much”;[[252]](#endnote-253) we are not in a position to either support or oppose his analysis. It is a question for economists rather than lawyers—that is, if you are willing to trust the economists. Otherwise, it is a coin flip.

# **Appendix**

## Allocation and Apportionment of Interest Deductions

In Year 1, Acme, a domestic corporation, incurs $200 of interest expense on a third-party borrowing. Acme owns U.S. operating assets with U.S. tax basis of $1,000. Acme’s U.S. business generates $600 of income in Year 1. Acme also owns stock of a single Country A CFC with stock basis of $1,000 and E&P of $1,000. CFC has zero basis in its operating assets and in Year 1 earns sales income that is tested income (i.e., not foreign base company sales income) of $1,000. CFC pays $180 of income tax to Country A in Year 1 (i.e., an effective foreign rate of 18 percent).

Acme’s Code. Sec. 951A inclusion is $820, and Acme must also include a Code. Sec. 78 gross-up of $180, bringing Acme’s total GILTI to $1,000. The Code. Sec. 250 deduction brings Acme’s GILTI down to $500. Because Acme has no pro rata share of QBAI and there are no tested loss CFCs, Acme’s inclusion percentage is 100 percent. Acme is therefore deemed to pay $144 of CFC’s foreign taxes under Code. Sec. 960(d).

Acme must allocate and apportion its deduction for the $200 of interest between Acme’s U.S. and foreign source income and across Acme’s Code. Sec. 904 income baskets. Interest is “allocated” to all gross income, so the allocation and apportionment exercise for interest expense is only an apportionment exercise.[[253]](#endnote-254) Acme is required to apportion interest expense according to the “tax book value” (“TBV,” which is essentially tax basis, with some modifications) of its assets, and Acme’s assets are categorized by the type of income they produce.[[254]](#endnote-255)

In this simplified example, we have U.S. assets with TBV of $1,000 and a single CFC with total TBV of $2,000 (because stock basis and E&P are counted in TBV when classifying CFC stock for apportionment purposes). The CFC has only foreign source tested income and this *would* give rise to apportionment of 1/3 U.S. source and 2/3 foreign source GILTI, except Treasury showed some mercy in exempting the TBV of the foreign assets to the extent they relate to the 50 percent deduction under Code. Sec. 250. All of CFC’s income is tested income. Thus, 50 percent of the $2,000 TBV of CFC is exempt.

This leaves $1,000 TBV of U.S. assets and $1,000 TBV of foreign GILTI assets. The $200 of interest deduction is therefore split evenly between U.S. and foreign assets. Thus, $100 of Acme’s interest deduction is apportioned to foreign source GILTI. This reduces the GILTI income in the Code. Sec. 904 basket from $500 to $400. The limitation in the GILTI Code. Sec. 904 basket is $400 x 21 percent = $84. Because the apportionment of $100 of interest expense also reduces Acme’s GILTI inclusion to $400, one might argue that Acme does, in fact, “break even.” In other words, Acme pays $84 of U.S. tax on its GILTI, and Acme is allowed a foreign tax credit of $84.[[255]](#endnote-256)

The problem is evident when we consider Acme’s $600 of other income from its U.S. business. This income is apportioned $100 of Acme’s interest deduction, rather than the full $200. Had there been no apportionment of interest expense to Acme’s GILTI, Acme would have had GILTI of $500 and a Code. Sec. 904 limitation of $500 x 21 percent = $105. Thus, the allowed foreign tax credit would have “paid for” the full U.S. tax on Acme’s GILTI, even without Acme’s use of any interest deductions against its GILTI inclusion. Arguably, this would be the result if GILTI operated as a “pure” minimum tax. Acme would have been able to use the full $200 of interest deduction against its U.S. income. Under the allocation and apportionment framework that Treasury implemented, however, Acme must apportion $100 of its interest deduction to GILTI and pay an additional $21 of tax.

## Overall Foreign Loss / Separate Limitation Loss / Overall Domestic Loss

GILTI has even more pronounced problems with Code. Sec. 904 when it comes to losses.[[256]](#endnote-257) The overall foreign loss (“OFL”), separate limitation loss (“SLL”) and overall domestic loss (“ODL”) rules in Code. Sec. 904 are intended to address the effects of losses in different baskets and smooth out the result over multiple years with various recapture and recharacterization mechanics. The denial of any foreign tax credit carryforwards or carrybacks for the GILTI basket can result in dramatic deadweight costs in loss and recapture years. To illustrate, let us look again at Acme, which continues to own a single CFC in Country A. Country A has undergone tax reform, and its tax rate has gone down to 14 percent. As of the start of Year 2, Acme has paid off all of its third party debt, so at least we no longer have to worry about apportioning interest deductions. Acme has also expanded its foreign operations in the form of a branch located in Country B. The foreign branch, however, gets off to a rocky start in Year 2. Acme has the following net items of income in the following categories:

|  |  |  |  |
| --- | --- | --- | --- |
| General | GILTI[[257]](#endnote-258) | Branch | US |
| 200  | 400  | (1000) | 500  |

The $1,000 loss in the branch basket constitutes an SLL under Code. Sec. 904(f)(5) and must be allocated among the “separate limitation incomes”—i.e., the positive amounts in the other foreign source income baskets—up to the aggregate amount of those separate limitation incomes. If the SLL exceeds that aggregate amount, the excess constitutes an OFL and reduces U.S. source income. The allocation of the branch basket SLL / OFL is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | General | GILTI | Branch | US |
| Y2 starting net income | 200  | 400  | (1000) | 500  |
| Allocate branch SLL / OFL | (200) | (400) | 1000  | (400) |
| After allocating branch SLL / OFL | 0  | 0  | 0  | 100  |

The foreign source income in the general and GILTI baskets is completely wiped out. The result is that, while CFC paid $112 of foreign tax to Country A (14 percent of $800 tested income) and otherwise would have an $89.60 deemed paid credit under Code. Sec. 960(d), there is zero limitation in the GILTI basket for Year 2, and the foreign tax credits are lost. Similar to the interest deduction apportionment exercise in Year 1, some might argue that this is fine and just because the $1000 of branch loss actually eliminated any U.S. tax liability with respect to GILTI. But the same rebuttal also applies: GILTI, as a minimum tax, is supposed to be completely zeroed out by any properly attributable foreign tax that meets or exceeds the 13.125 percent minimum effective rate threshold. CFC paid 14 percent tax to Country A—thus, if the system worked, the $84 U.S. tax liability with respect to the $400 GILTI inclusion should be “paid for” by Acme’s $89.60 deemed paid foreign tax credit. The $1,000 branch loss would be allocable only to Acme’s $200 foreign source general basket income and its $500 of U.S. income, resulting in a $300 net operating loss. However, because GILTI is subject to the Code. Sec. 904 framework, the income in the GILTI basket attracts $400 of the branch loss and the Country A foreign taxes go to waste. And, as we will see, the real detriment of these rules’ application is apparent when the branch basket has income in Year 4.

The OFL rules’ effects are even worse when, in Year 3, Acme has positive foreign source income in the general and GILTI baskets of $100 and $300, respectively, but only manages to break even in the branch basket. The $400 OFL from Year 2 is required to be recaptured thus:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | General | GILTI | Branch | US |
| Y3 starting net income | 100  | 300  | 0  | 30  |
| OFL recapture | (100) | (300) |  | 400 |
| After OFL recapture | 0  | 0  | 0 | 430  |

Once again, CFC has paid tax to Country A (this year it was $84), but Acme has zero limitation in the GILTI basket. This is a particularly harsh result because Acme has $430 of U.S. taxable income and $90.30 of U.S. tax, but it has zero foreign tax credits in spite of having paid $196 of foreign taxes over the past two years.

All of this might be forgivable if, when Acme has a bumper year in Year 4, the sudden flush of Code. Sec. 904 limitation is usable. Sadly, the absence of foreign tax credit carryforwards in the GILTI basket means this is not the case. In Year 4, Acme’s foreign branch business finally gets it together and has net income of $1,000. The general and GILTI baskets are also doing well, with $100 and $500 of net income, respectively. Because each of the general and GILTI foreign source income baskets have had to “donate” their incomes to cover the branch basket’s SLL in Years 2 and 3, in Year 4 the branch basket has to even the books and effectively pay back the other baskets. Thus, the $1,000 of branch basket income is recharacterized as $300 of general basket income and $700 of GILTI basket income:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | General | GILTI | Branch | US |
| Y4 starting net income | 100  | 500  | 1000  | 500  |
| SLL recapture recharacterization | 300  | 700  | (1000) |  |
| After SLL recapture recharacterization | 400 | 1200  | 0  | 500  |

CFC has paid $140 of tax to Country A in Year 4 and thus Acme is deemed to pay $112 of foreign taxes under Code. Sec. 960(d). Because the branch basket has settled accounts with the GILTI basket, there is ample limitation to take the $112 foreign tax credit. In fact, there is total GILTI basket limitation of $252 ($1,200 x 21 percent)! The result is that the $140 of surplus limitation goes to waste. If Acme had been able to carry forward its deemed paid credits of $156.80 from Years 2 and 3, the issue would be limited to timing. Because those prior year foreign tax credits are dead and gone, however, the distortion is very permanent. Acme has included $1,200 of GILTI but was able to claim a foreign tax credit of only $112. The result is that Acme paid $140 of U.S. tax with respect to its GILTI that is not covered by foreign tax credits, in spite of its only CFC being subject to a foreign effective tax rate of 14 percent.

In Year 5, Acme’s foreign businesses are still in the black, but its U.S. business hits a slump. Acme has an ODL that, like an SLL, must be allocated across Acme’s foreign source income categories:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | General | GILTI | Branch | US |
| Y5 starting net income | 100  | 400  | 100  | (300) |
| ODL allocation | (50) | (200) | (50) | 300  |
| After ODL allocation | 50  | 200  | 50  | 0  |

CFC paid $112 of Country A tax on its $800 of tested income, resulting in a $90 deemed paid foreign tax credit, but the ODL allocation to the GILTI basket reduces Acme’s limitation to $42. In Year 6, Acme’s U.S. business recovers and earns $600. As with an SLL, the U.S. source income must pay back the foreign source income baskets for their prior year absorption of the $300 ODL:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | General | GILTI | Branch | US |
| Y6 starting net income | 100  | 500  | 300  | 600.00  |
| ODL recapture recharacterization | 50  | 200  | 50  | (300) |
| After ODL recapture recharacterization | 150  | 700  | 350  | 300  |

The GILTI basket now has $147 of limitation, but CFC only paid $140 of foreign tax, yielding a foreign tax credit of $112. $35 of that limitation goes to waste. This is a phenomenon similar to the one in Year 4, as the GILTI basket is infused with excess limitation to make up for the prior year loss allocation, but Acme has no GILTI basket carryforwards to use.

1. \* The authors gratefully acknowledge helpful comments from Sam Pollack, John McDonald, Ethan Kroll, Maher Haddad and Gary Sprague, and the valuable assistance of Emily Berg, Shelbi Nelson and Neil Donetti. [↑](#endnote-ref-2)
2. *See* Daniel Shaviro, *The Crossroads Versus the Seesaw: Getting a “Fix” on Recent International Tax Policy Developments*, 69 Tax L. Rev. 1, 3 (2015) (“An alternative metaphor…is that of the seesaw.”) [↑](#endnote-ref-3)
3. See, e.g., Reuven S. Avi-Yonah, Diane M. Ring & Yariv Brauner, U.S. International Taxation Cases and Materials 3 (2019) (“While the source country is granted the prior right to tax all income and the residence country has the primary obligation to prevent double taxation, this is a concession to the source country’s ability to impose taxes first…”). [↑](#endnote-ref-4)
4. See Bret Wells & Cym H. Lowell, *Income Tax Treaty Policy in the 21st Century: Residence v. Source, 5 Colum. J. of Tax Law 1*, 4-5 (2013) (“Our model income tax treaties (both OECD and UN) were designed to minimize income that would be allocated to source countries, with the residue allocated to residence countries. This process occurred in the 1920s….”). [↑](#endnote-ref-5)
5. See Ruth Mason, *The Transformation of International Tax*, 114 Am. J. Int’l Law 353, 357 (2020) (“the replacement of offices, factories, and warehouses with immaterial websites and cheap third-party contracts…has enabled multinationals to avoid tax nexus in source states.”). [↑](#endnote-ref-6)
6. See Code Secs. 951 through 956. [↑](#endnote-ref-7)
7. See Wells & Lowell, *supra* note 3, at 7 (treaty policy “spawned the phenomenon of homeless income”); Edward D. Kleinbard, Stateless Income’s Challenge to Tax Policy, 132 Tax Notes 1021 (2011) (2012) (“stateless income”). [↑](#endnote-ref-8)
8. Code Sec. 59A. [↑](#endnote-ref-9)
9. Code Sec. 163(j). [↑](#endnote-ref-10)
10. *See* *infra* Part IV.C (describing digital services taxes). [↑](#endnote-ref-11)
11. The OECD is an international organization that “provide[s] a unique forum and knowledge hub for data and analysis, exchange of information, best-practice sharing, and advice on public policies and international standard-setting.” *About*, OECD, <https://www.oecd.org/about/>. It produces soft law, and lacks the power to force nations to change their statutes or treaty arrangement. However, it can provide a focal point for international cooperation. [↑](#endnote-ref-12)
12. The BEPS project is detailed *infra* Part IV.B. [↑](#endnote-ref-13)
13. The Inclusive Framework is a shorthand for “OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting.” The Inclusive Framework calls for increases in both source and residence taxation, but as discussed *infra* Part V.B, its designers hope that the prospect of residence tax increases will lead to greater source taxation. [↑](#endnote-ref-14)
14. *See infra* Part V.B (describing Pillar Two and the GloBE tax). [↑](#endnote-ref-15)
15. GILTI is the acronym for the tax imposed on “Global Intangible Low-Taxed Income” contained in Code Sec. 951A. [↑](#endnote-ref-16)
16. *See* *infra* Part V.C (explaining the new corporate minimum tax on book income, or “CAMT”). [↑](#endnote-ref-17)
17. It is worth noting that not all agree this consensus is worth preserving; there are a number of proponents for taxing the foreign income of U.S. multinationals and their related companies at the same rates and under the same conditions as the income of wholly domestic enterprises. *See, e.g*., J. Clifton Fleming, Jr., Robert J. Peroni & Steven Shay, *Two Cheers for the Foreign Tax Credit, Even in the BEPS Era*, 91 Tulane L. Rev. 1, 42 (2016) (“In prior work, we have explained why taxation of residents on their worldwide incomes…should be practiced…for reasons of fairness and efficiency”); David L. Cameron & Philip F. Postlewaite, *Incremental International Tax Reform: A Review of Selected Proposals*, 30 Nw. J. Intl L. & Bus. 565, 567 (2010) (“Proponents of such a system maintain that exemption systems include their own set of incentives that distort investment decisions bytaxpayers that are more problematic than those that exist under a properly designed full inclusion system.”); Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 Harv. L. Rev. 1573, 1593 (2000) (“the obvious solution…would be to repeal deferral, that is, to apply Subpart F to all income rather than limiting it to mostly passive income.”). However, there is no indication that Congress has shifted its position on this issue; indeed, the enactment of GILTI in the 2017 tax act indicates the opposite. [↑](#endnote-ref-18)
18. This discussion assumes that the tax rate differential cannot be explained by a difference in the quantum of services provided to taxpayers by the various governments. From a taxpayer’s perspective, what matters is the overall cost of operations in each jurisdiction. Taxpayers do not benefit from avoiding $1,000 of taxes if they have to pay for $1,000 of expenses that would otherwise have been provided “for free” by the higher tax jurisdiction. For example, a taxpayer should be indifferent (tax credit issues aside) between paying $150 in taxes and enjoying “free” sewer services and paying $100 in taxes and paying $50 for sewer services. [↑](#endnote-ref-19)
19. The United States has made it quite difficult (and expensive) for U.S. corporations to re-cast themselves as foreign corporations for tax purposes, and is discussing making it harder still. *See* Code Sec. 7874 (anti-inversion rule); Cong. Res. Serv., *Corporate Expatriation, Inversions, and Mergers: Tax Issues* 21-22 (June 17, 2021), <https://sgp.fas.org/crs/misc/R43568.pdf> (listing legislative proposals); Senate Finance Committee BBBA legislative text, available at <https://www.finance.senate.gov/download/finance-committee-build-back-better-text-> (proposing changes to Code Sec. 7874, including reduced ownership thresholds for inversions, expanded definition of domestic entity acquisition and expanded treatment of partnerships); Wade Sutton et al., *Inversion 2.0: The Proposal to Expand the Scope of Section 7874*, 175 Tax Notes Federal 27 (Apr. 4, 2022) (summarizing recent proposals to tighten the inversion rules). [↑](#endnote-ref-20)
20. *See* Daniel N. Shaviro, Fixing U.S. International Taxation 72 (Oxford 2014) (“[I]f the U.S. tax rules were sufficiently aggressive in currently reaching resident multinationals’ foreign source income…and thus greatly raised the price of domestic incorporation, U.S. tax lawyers might start winning more of the in-house arguments regarding where to incorporate.”). FTX, a crypto-currency exchange, was established as an Antigua and Barbuda corporation with a head office is in the Bahamas. Its founder and CEO, Sam Bankman-Fried, is the son of two tax professors at Stanford Law School (though his father has taken a leave of absence to work for Sam). [↑](#endnote-ref-21)
21. *See* Office of Tax Policy, Dept. of Treas., The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study ix (Dec. 2000) (describing “deferral”) [hereinafter Tax Policy Study]. [↑](#endnote-ref-22)
22. This effect was recognized at least as early as the 1950s. *See* Vasujith Ram, *Contextualizing the History of Subpart F*, 161 Tax Notes 315, 316 (Oct. 15, 2018) (describing how legal scholars pushed for the extension or expansion of deferral in the 1950s despite understanding that “subsidiaries could be (and were) incorporated abroad in low-tax jurisdictions to take advantage of the loophole under U.S. tax law”). [↑](#endnote-ref-23)
23. *See id*. at 316 (explaining that scholars saw deferral as a “boon” because it “promoted American investment and private enterprise in ‘free world’ countries around the world, serving America’s economic as well as geo-political interests”). Stanley Surrey continued to support deferral as late as 1958. *See id*. at 320-21; Stanley S. Surrey, *United States Taxation of Foreign Income*, 1 J. L. & Econ. 72, 93-94 (1958) (defending the use of a “coordinating corporation…located in a tax haven country”). Indeed, Congress came close to passing a bill that would have extended the deferral privileges to the income of certain U.S. corporations derived from operations in less-developed countries. *See* Ram, *supra* note 21, at 322 (describing “Boggs Bill” passed by the House on May 18, 1960). [↑](#endnote-ref-24)
24. *See* Ram, *supra* note 21, at 322 (Douglas Dillon, President Kennedy’s Treasury Secretary, explained his shift from supporting the Boggs Bill to supporting a proposal to largely end deferral less than a year later by pointing to increasing deficits in the balance of payments and the “exponential rise in the number of tax haven companies…the number rose from 2,100 to 2,850 in the immediately preceding year”); Tax Policy Study, *supra* note 20, at 8 (The “use of tax haven corporations to obtain a tax advantage for income otherwise earned in a high-tax foreign country was a new and rapidly growing phenomenon….[O]ver one-third of the approximately 500 American-owned firms in Switzerland had been formed in 1960.”). [↑](#endnote-ref-25)
25. President Kennedy’s “Special Message to the Congress on Gold and the Balance of Payments Deficit” on February 6, 1961, argued against “penaliz[ing] legitimate private investment abroad” while advocating legislation “to prevent the abuse of foreign ‘tax havens’ by American capital abroad as a means of tax avoidance.” Ram, *supra* note 21, at 326 (quoting Kennedy speech); John F. Kennedy, “Special Message to the Congress on Gold and the Balance of Payments Deficit,” Feb. 6, 1961 (1961), 1961 Pub. Papers 57, 64. [↑](#endnote-ref-26)
26. This language is still found in Articles 5 and 7 of the United States Model Income Tax Convention (Feb. 17, 2016), and has been incorporated in most of the United States’ dual tax treaties. *See* Allison Christians et al., United States International Taxation 204 (2d ed. 2011) (“Generally, income tax treaties provide that business income is taxable in a country only if an enterprise possesses a ‘permanent establishment’ in such country….”). [↑](#endnote-ref-27)
27. *See* United States Model Income Tax Convention, at Arts. 11 & 12 (Feb. 17, 2016) (eliminating withholding tax at source for most interest and royalty payments) [hereinafter 2016 U.S. Model Treaty]. [↑](#endnote-ref-28)
28. *See* Tax Policy Study, *supra* note 20, at 8 (describing “sales subsidiaries with no foreign economic activities, which merely booked a sale and took a percentage of profit”). [↑](#endnote-ref-29)
29. At least some of these countries were widely excoriated. *See* Vito Tanzi, *Globalization and the Work of Fiscal Termites*, 38 Fin. & Dev. 34, 36 (Mar. 2001) (advocating “strong, punitive actions by industrial countries” to “drive[] out of existence…offshore financial centers and tax havens”). But others have pointed out that many high-tax countries, including the United States, provided comparable tax benefits for some taxpayers without encountering similar opprobrium. *See* Lee A. Sheppard, *Withholding Policy: Don’t Ask, Don’t Tell, Part 2*, 42 Tax Notes 635, 635 (May 8, 2006) (describing Britain and the United States as tax havens). [↑](#endnote-ref-30)
30. Rather than terminating its tax treaty with the Netherlands Antilles, a noted tax haven, the United States provided a statutory exemption that granted most taxpayers exactly the benefits they received under the treaty. *See* Staff of the Joint Comm. of Tax’n, General Explanation of the Tax Reform Act of 1984 at 392-94 (1985) (explaining the prospective repeal of the statutory withholding tax). Times may be changing; in July, Treasury informed Hungary that it is cancelling the Hungarian-U.S. tax treaty as of January 1, 2024, because of Hungary’s reduction of its domestic corporate tax rate would exacerbate Hungary’s status as a tax treaty-shopping country. Thomson Reuters Tax & Accounting, *U.S. Ending Tax Treaty With Hungary*, Thomson Reuters (July 14, 2022), <https://tax.thomsonreuters.com/news/u-s-ending-tax-treaty-with-hungary/>. Some speculated the cancellation was also retaliation for Hungary’s decision to block the European Union from finalizing details of the Inclusive Framework, discussed *infra* Part V.B. *See id*. [↑](#endnote-ref-31)
31. Whether U.S. companies (such as Acme) were or are advantaged or disadvantaged relative to foreign multinationals (such as Nederland) has always been a matter of dispute—but their advantage over Basic and Indus was clear. By the turn of the 21st century, many high-tax countries followed the U.S. lead and enacted anti-tax haven statutes of various degrees of effectiveness. *See* Tax Policy Study, *supra* note 20, at 59 (“15 of the 21 countries that have adopted CFC legislation were among the 25 jurisdictions with the highest average foreign direct investment outflows between 1990 and 1994”). [↑](#endnote-ref-32)
32. *See* Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 Wm. & Mary L. Rev. 923, 926 (2010) (“Tax havens threaten the long-term fiscal health of the country, undermining the ability of the government to address the pressing economic and social emergencies of the day, and thus the integrity of the modern state itself. The alarm has been raised, the gauntlet has been thrown; leading academics have been decrying the use of tax havens as ‘tax witchcraft,’ and even the President of the United States himself has been imploring Congress to act. Is this a description of the state of U.S. tax policy in 2010? No—it describes international tax policy debate in the late 1950s and early 1960s.”); note 23 *supra*, at 325 (detailing growth in tax haven companies); Tax Policy Study, *supra* note 20, at 8 (same). [↑](#endnote-ref-33)
33. See *infra* note 45 and accompanying text. [↑](#endnote-ref-34)
34. This generosity extended only if and to the extent the taxpayer continued to use these profits to expand its foreign business operations. If and when such profits were invested in the stocks or securities of related U.S. entities, or certain other tangible or intangible property used in U.S. business operations, the taxpayer was required to pay to the U.S. government the difference between the foreign taxes it had already paid on such income and the tax it would have paid on such income had it been earned domestically. *See* Code Sec. 956. [↑](#endnote-ref-35)
35. *See* Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Taxation,* 61 Tax L. Rev. 169, 233 (2008) (describing subpart F as a “bet” that taxpayers would be unwilling to change their business operations to avoid subpart F—a bet that Congress lost). [↑](#endnote-ref-36)
36. The definition of “controlled foreign corporations” is contained in Code Sec. 957. It includes any foreign corporation which is more than 50 percent owned (as measured by vote or value), *see* Code Sec. 957(a), by “U.S. shareholders.” “U.S. shareholders” is itself a defined term; it includes U.S. persons who own or are deemed to own at least 10 percent of the shares of the foreign corporation. *See* Code Sec. 951(b) (defining “U.S. shareholder”); Code Sec. 958 (rules for determining stock ownership). [↑](#endnote-ref-37)
37. Code Sec. 951(a). [↑](#endnote-ref-38)
38. Code Sec. 952(a)(2). [↑](#endnote-ref-39)
39. The special rule related to shipping income, formerly found at Code Sec. 954(a)(4), was eliminated by the American Jobs Creation Act of 2004. *See* Pub. L. No. 108-357, § 415(a)(1). [↑](#endnote-ref-40)
40. Code Sec. 951(a)(1). [↑](#endnote-ref-41)
41. Code Sec. 954(d)(1). [↑](#endnote-ref-42)
42. Code Sec. 954(e). [↑](#endnote-ref-43)
43. A U.S. shareholder may elect to exclude income subject to foreign tax at a rate approaching the U.S. tax rate, even if it otherwise would constitute foreign base company income. *See* Code Sec. 954(b)(4). Subpart F income also excludes income which is “effectively connected with the conduct of a trade or business within the United States” and which therefore would have already been subject to U.S. tax. *See* Code Sec. 952(b). [↑](#endnote-ref-44)
44. *See*, *e.g.*, H.R. Rep. No. 87-1447, at 57-58. The House of Representatives Ways and Means Committee noted that testimony convinced the committee “that many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income. In part your committee has met this problem elsewhere in this bill…through the addition of a new subsection to the existing section 482 setting up specific factors to be taken into account in more accurately allocating income from purchases and sales of goods between American corporations and their controlled foreign subsidiaries. However, certain of the provisions set forth in this section are also designed to meet this problem of diversion of income from U.S. taxation” (quoting President Kennedy’s 1961 address, in which he stated, “Recently more and more enterprises organized abroad by American firms have arranged their corporate structures aided by artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and similar practices which maximize the accumulation of profits in the tax haven-so as to exploit the multiplicity of foreign tax systems and international agreements in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad.”). [↑](#endnote-ref-45)
45. It largely turned on whether one thought that the anti-abuse rules adopted by other jurisdictions were as stringent as those employed by the United States. Views differed. *See* A. Kristina Zvinys, *CFC Rules in Europe*, Tax Found. (Aug. 20, 2020), <https://taxfoundation.org/controlled-foreign-corporation-rules-cfc-rules-in-europe-2020/> (describing variations in CFC rules in Europe); OECD/G20 Base Erosion and Profit Shifting Project, Designing Effective Controlled Foreign Company Rules, Action 3: 2015 Final Report 11 (2015), <http://dx.doi.org/10.1787/9789264241152-en> (“Since the first CFC rules were enacted in 1962, an increasing number of jurisdictions have implemented these rules…. However, existing CFC rules have often not kept pace with changes in the international business environment, and many of them have design features that do not tackle BEPS effectively.”). [↑](#endnote-ref-46)
46. *See* Reuven S. Avi-Yonah, *The Logic of Subpart F: A Comparative Perspective*, 79 Tax Notes 1775, 1776 (1998) (“The fundamental problem raised by subpart F today is that this dichotomy [between manufacturing or similar operations and the use of tax havens], as envisaged by Congress in 1962, is no longer valid. Specifically, the assumption that active business operations (as opposed to passive income and base company operations) cannot be conducted in low-tax jurisdictions is incorrect.”). [↑](#endnote-ref-47)
47. *See, e.g.*, Chris Van Egeraat & Proinnsias Breathnach, *The Manufacturing Sector,* *in* Understanding Contemporary Ireland 128, 129 (Brendan Bartley & Rob Kitchin eds., 2007) (“In addition to the availability of cheap labour, the incentives offered to attract outside investment [in Ireland] included substantial capital grants and, in particular, the exemption from taxation of all profits derived from exports. Tariffs on imports were also gradually reduced during the 1960s and 1970s. The attractiveness of this package was reflected in a substantial build-up of inward investment in the two decades after 1960, boosted in particular by Ireland’s accession to the European Economic Community (EEC) in 1973. Between 1961 and 1981, employment in foreign manufacturing firms grew almost fourfold. The USA became by far the most important foreign investment source in this period, accounting for over 40 per cent of employment in foreign manufacturing firms in 1981.”); Abdul Karim, Noor-Al Huda, et al., Foreign Direct Investment in Manufacturing Sector in Malaysia (Annual Conference of the Australian Agricultural and Resource Economics Society, 2003), <https://core.ac.uk/download/pdf/6563957.pdf> (“Because Malaysia’s labour force was relatively inexpensive, educated and abundant, it fulfilled the needs of foreign firms…. From 1980 to 1989, the average annual FDI flow into Malaysia’s manufacturing sector was RM2.33 billion (nearly US$1 billion). In 1980, it was about RM0.73 billion (US$0.34 billion) but in 1990, it increased significantly to RM17.63 billion (US$6.5billion).”); Wong Hock Tsen, *The Determinants of Foreign Direct Investment in the Manufacturing Industry of Malaysia*, 26 J. of Econ. Cooperation among Islamic Countries 91, 106 (2005) (In the 1980s and 1990s, Malaysia’s “pool of relatively cheap and well-trained labour was an important factor that attracted FDI, particularly in labour-intensive sectors such as electrical and electronic products. The tightness of the labour market in the 1990s . . . together with the globalisation of the world economy made FDI in Malaysia shift to high-value added and capital intensive activities, including high technology, research and development . . . and knowledge-intensive industries.”); Chia Siow Yue, *Singapore: Towards a Knowledge-based Economy, in* Industrial Restructuring in East Asia: Towards the 21st Century 169, 177 (Seiichi Masuyama, Donna Vandenbrink, & Chia Siow Yue eds., 2001) (“Up to 1990, Singapore was the largest recipient of FDI among Asian developing economies. FDI played a particularly crucial role in Singapore’s pursuit of export manufacturing and the development of its financial centre. By adopting a liberal FDI policy regime and providing effective trading and financial infrastructure, Singapore enjoyed a first-mover advantage as a production base for MNCs looking for a location to produce the labour-intensive parts of the value chain.”); Avi-Yonah, *supra* note 16, at 1596 (“Corporate income from cross-border transactions is…unlikely to be taxed in the supply jurisdiction because production can take place in production tax havens.”). [↑](#endnote-ref-48)
48. *See* Arti Yadav & Badar Alam Iqbal, *Foreign Direct Investment in the Era of Digitalization and Environmental Sustainability, in* Contemporary Issues in International Business and Entrepreneurship 68, 75–76 (Lasse Torkkeli ed., 2021) (“Digitalization has a great significance for foreign investors in terms of process simplification and paperless transactions devoid of any bias or error. Various transactions related to banks, bills payment, or financial transactions can be done from anywhere at any time…. Internationalization strategies of multinational organizations also have an impact on digitalization, as now physical presence is not necessary to engage or operate in a global market.”); OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report 68 (“technological advances increasingly make it possible for businesses to carry on economic activity with minimal need for personnel to be present.”). But see *infra* note 143 (arguments against the characterization of digital businesses as needing only few employees). [↑](#endnote-ref-49)
49. See, e.g., McKinsey Global Institute, Digital Globalization: The New Era of Global Flows at 15 (Mar. 2016), <https://www.mckinsey.com/~/media/mckinsey/business%20functions/mckinsey%20digital/our%20insights/digital%20globalization%20the%20new%20era%20of%20global%20flows/mgi-digital-globalization-full-report.ashx> (“[A]pproximately one-third of high-tech companies are moving manufacturing or assembly closer to end-user markets; this number is up by 25 percentage points from 2010.”); Pankaj Ghemawat, Regional Strategies for Global Leadership, Harv. Bus. Rev., Dec. 2005, <https://hbr.org/2005/12/regional-strategies-for-global-leadership> (“The leaders of these successful companies seem to have grasped two important truths about the global economy. First, geographic and other distinctions haven’t been submerged by the rising tide of globalization; in fact, such distinctions are arguably increasing in importance. Second, regionally focused strategies are not just a halfway house between local (country-focused) and global strategies but a discrete family of strategies that, used in conjunction with local and global initiatives, can significantly boost a company’s performance.”). About fifteen years ago, consulting firms were advising multinational companies to regionally diversify to gain market power. *See* C.K. Prahalad & Hrishi Bhattacharyya, Twenty Hubs and No HQ, Strategy+Bus. (Feb. 26, 2008), <https://www.strategy-business.com/article/08102> (“What if a company’s executives truly took seriously the new middle class emerging in so many countries? How would they organize their companies to provide products and services for those new consumers? They could start with the 20 countries in the world that best serve as gateways to nearby regions. Drawing on capital, talent, and resources from those gateway countries, companies would establish their own corporate hubs in each of them: offices with enough capabilities in marketing, manufacturing, and logistics to maintain a powerful presence in all the markets of that region. Companies would then integrate these hubs into a global network that distinguished their company from its competitors around the world.”). [↑](#endnote-ref-50)
50. These regulations, promulgated as Reg. §§ 301.7701-1 to -3, allowed foreign and domestic eligible entities to elect their character as either corporations or flow-through entities (including “disregarded entities” for eligible entities with a single owner) for U.S. tax purposes. They became effective in 1997. [↑](#endnote-ref-51)
51. As described below, *see infra* Part III.A.2, these regulations made it easy for taxpayers to create “hybrid entities” treated as “tax nothings” for U.S. tax purposes but as corporations for foreign tax purposes. [↑](#endnote-ref-52)
52. One development we do not explore in depth, but is along the same lines, is the IRS’s issuance of Notice 2007-13, which narrowed the application of the foreign base company services income rules by limiting “substantial assistance” to assistance provided by U.S. persons only, and providing a cost-based safe harbor. *See* Notice 2007-13, 2007-1 C.B. 410 (Jan. 9, 2007) (“Since the regulations were published in 1968, there has been a substantial expansion in the reach of the global economy, particularly in the provision of global services. As a result, many of the U.S. multinationals that provide services outside of the United States currently have globally integrated businesses with support capabilities for unrelated customer projects in different geographic locations, largely based on factors such as expertise and cost efficiencies.”) [↑](#endnote-ref-53)
53. Code Sec. 954(d)(1) (foreign base company sales income is “income…derived in connection with the purchase of property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person where—

	1. The property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and(B) The property is sold for use, consumption, or disposition outside of such foreign country….”). [↑](#endnote-ref-54)
54. If Country A, B, C, D, and E are all foreign countries, the immediate harm is to foreign government treasuries rather than to the United States treasury. However, inasmuch as these techniques have the capacity to turn high-tax foreign jurisdictions into low-tax foreign jurisdiction, offshore operations become more profitable, and thus U.S. businesses are more likely to choose to operate in foreign locales, rather than the United States. Thus foreign-to-foreign base erosion presumably harms the U.S. economy. See further discussion in Part III.A.4, *infra*. On the other hand, absent subpart F or some other control, the same structure could be used to reduce the taxable income of U.S. companies (i.e., Corp 1 or Corp 4 could be U.S. corporations), directly reducing U.S. tax revenues—but also increasing the after-tax returns to U.S. operations and making investment abroad less likely. [↑](#endnote-ref-55)
55. Code Sec. 482 allows the IRS to “distribute, apportion, or allocate gross income, deductions or allowances” between related taxpayers when “necessary in order to prevent evasion of taxes or reflect the income” of the taxpayers. [↑](#endnote-ref-56)
56. Tax Policy Study, *supra* note 20, at 64 (“If the CFC manufactures the property that it sells, the sales income generally will not be subject to the [foreign base company sales income] rules.”). [↑](#endnote-ref-57)
57. The “branch rule” is contained at Code Sec. 954(d)(2). [↑](#endnote-ref-58)
58. Code Sec. 954(d)(2). [↑](#endnote-ref-59)
59. Reg. § 1.954-3(b). It is worth noting that the Sixth Circuit in the *Whirlpool* case, discussed *infra* note 61, completely ignored this regulatory language. [↑](#endnote-ref-60)
60. The income of the manufacturing branch presumably would fall outside the scope of subpart F because its income would be generated from manufacturing. *See* Reg. § 1.954-3(b)(4), Example 3 (branch income escapes characterization as foreign base company sales income because branch engaged in manufacturing; absence of tax at source irrelevant). The income of the remainder of the entity would be foreign base company sales income unless its customers were located in its country of incorporation. [↑](#endnote-ref-61)
61. *See Ashland Oil Co. v. Comm’r*, 95 T.C. 348, 357-58 (1990) (holding that a separately incorporated entity cannot be considered a “branch” for subpart F purposes); *Vetco v. Comm’r*, 95 T.C. 579 (1990) (same). [↑](#endnote-ref-62)
62. Indeed, the IRS issued a revenue ruling adopting this position in 1975. *See* Rev. Rul. 75-7, 1975-1 C.B. 244 (1975). Although it reversed its position in Rev. Rul. 97-48, *see* Rev. Rul. 97-48, 1997-2 C.B. 89 (1997), most taxpayers gave scant if any credence to this reversal and continued to utilize the arrangement. *See* David G. Noren, *Tax Havens and Tax Policy: How Should the U.S. Tax System Treat Income Earned by Multinationals in Low-Tax Jurisdictions?*, 88 Taxes 27, 30 (Mar. 2010) (“Many taxpayers continued to rely on attribution, however, based on a widespread view that Rev. Rul. 97-48 was an incorrect application of the relevant statute.”).Nor did the IRS litigate such cases. The taxpayer’s loss in the recently decided *Whirlpool* case was shocking to practitioners. *See* *Whirlpool Financial Corp. v. Comm’r*, 19 F.4th 944 (6th Cir. 2021), *petition for cert. filed* No. 22-9 (U.S. June 30, 2022) (treating a disregarded Mexican manufacturing branch wholly owned by a Luxembourgian corporation as a wholly owned subsidiary of that Luxembourgian corporation and as generating foreign base company sales income for that “parent” despite the existence of a contract manufacturing agreement, which should have caused the sales income to fall outside the definition of foreign base company sales income). Some suggested the decision would have limited implications “beyond the specific facts of the case.” Lowell D. Yoder et al., *Implications of The Sixth Circuit’s Whirlpool Opinion*, MWE (Dec. 21, 2021), <https://www.mwe.com/insights/implications-of-the-sixth-circuits-whirlpool-opinion/>. It was a 2-1 panel decision, and the taxpayer has filed for a writ of certiorari. [↑](#endnote-ref-63)
63. Guidance Regarding Foreign Base Company Sales Income, 73 Fed. Reg. 10716, 10718 (proposed Feb. 28, 2008). [↑](#endnote-ref-64)
64. *Id*. at 10719. [↑](#endnote-ref-65)
65. Reg. § 1.954-3(a)(iv)(a). [↑](#endnote-ref-66)
66. Guidance Regarding Foreign Base Company Sales Income, 73 Fed. Reg. at 10718 (“Final regulations addressing [foreign base company sales income] were first published in 1964 (TD 6734, 29 FR 6392). Since then, global economic expansion and globalization have led to significant changes in manufacturing. Many multinational groups have extensive manufacturing networks that straddle geographic borders. These cross-border manufacturing networks are created primarily to leverage expertise and cost efficiencies. In addition, the use of contract manufacturing arrangements has become a common way of manufacturing products because of the flexibility and efficiencies it affords. Accordingly, updated rules in this area are important to the continued competitiveness of U.S. businesses operating abroad.”). Of course, those flexibilities and efficiencies would continue to exist in the absence of tax benefits! [↑](#endnote-ref-67)
67. *See* Noren, *supra* note 61, at 30 (“The compromise at the heart of these regulations is to allow taxpayers to reap the benefits of tax competition through the use of low-tax principal/entrepreneur entities, but only where such entities exhibit some significant functionality beyond bearing risk and owning rights to IP.”); *see also* Semiconductor Industry Association, Comment Letter on Providing Guidance Regarding Foreign Base Company Sales Income (May 22, 2008) (“[C]ompanies with identical facts can end up with completely different tax results, simply based on whether they have favorable tax situations in particular countries, which are often driven by the number of employees they can maintain in the country where the contract manufacturing is located.”); Information Technology Industry Council, Comment Letter on Proposed Regulations Providing Guidance Regarding Foreign Base Company Sales Income (June 27, 2008) (The “sole focus on employees is too narrow to adequately measure contributions to manufacturing.”); Cisco Systems, Inc., Comment Letter on Proposed Regulations Providing Guidance Regarding Foreign Base Company Sales Income (June 28, 2008) (“The substantial contribution rules require CFC employee activity in the face of a trend—at least in the case of the manufacture of high tech products—towards more automation of manufacturing and quality control and assurance processes, and less employee involvement. The determination of whether a CFC makes a substantial contribution to the manufacture of products should be based both on the CFC’s assets (including intangible property needed for manufacturing) and activities.”). [↑](#endnote-ref-68)
68. See Lipeles et al., *Making the Substantial Contribution to Manufacturing Exception Work*, 92 Taxes 5 (May 1, 2014) (“Unfortunately, in many cases, IRS Exam teams appear to reject every pro-taxpayer inference from the guidance we do have in order to reach a negative conclusion on the substantial contribution test. In contrast to the reasonable positions in the preamble, the regulations, the examples, and the 2013 rulings, IRS Exam teams are aggressively challenging taxpayer positions on the substantial contribution test, even going so far as to create their own criteria for measuring whether a CFC’s contribution is ‘substantial.’”); Alston & Bird LLP, *IRS Issues Final and Temporary Contract Manufacturing Regulations*, Lexology (Jan. 15, 2009), https://www.lexology.com/library/detail.aspx?g=82fb5e54-f9b9-40fa-86c1-bfdcfbcc8eb9(“[C]ompliance with these new rules, especially in terms of their application in a branch setting, may require corporations to restructure their operation.”). [↑](#endnote-ref-69)
69. This was always easier if the highly taxed manufacturer was an unrelated company, since there would be no reason for it to agree to be undercompensated. In turn, these contracts with unrelated companies were used to establish the appropriate market prices for contracts with related companies. [↑](#endnote-ref-70)
70. *See* *infra* Part IV.B.3 (regarding the broad consensus around “DEMPE” functions and the remuneration of “value creation” activities). [↑](#endnote-ref-71)
71. Such distributors are denominated “limited risk” distributors and, like contract manufacturers, are assigned a return commensurate with their “routine” activities. *See* Paul Sutton, *Limited Risk Distribution Agreements—Key Considerations for Documenting Intercompany Arrangements*, LCN Legal (Jan. 5, 2018), <https://lcnlegal.com/limited-risk-distribution-agreements-key-considerations-for-documenting-intercompany-arrangements/> (“The essence of the arrangement is of course to de-risk the role of the intra-group distributor, resulting in a correspondingly lower return or margin for the distributor.”). [↑](#endnote-ref-72)
72. The process of determining a foreign or domestic entity’s classification for U.S. tax purposes under what were called the *Kintner* regulations was not straightforward, and the check-the-box regulations were promulgated in large part out of a sense of futility that taxpayers could achieve the desired classification through framing of the entity’s formation documents. *See, e.g.*, David R. Sicular, *The New Look-Through Rule: W(h)ither Subpart F?*, 115 Tax Notes 349, 359 (Apr. 23, 2007) (“Entity classification thus was often effectively elective, but making the ‘election’ required hard work and expense that was otherwise unproductive.”); Hugh M. Dougan et al., *“Check the Box”—Looking Under the Lid*, 75 Tax Notes 1141 (May 26, 1997) (“The Service had grown increasingly dissatisfied with the formalities of this system in light of changing circumstances—particularly the proliferation of state laws authorizing the creation of ‘limited liability companies’ (‘LLCs’)—a hybrid form of business entity that offered both limited liability to all members and a system of representative management. It concluded that well-advised taxpayers were essentially in a position to choose their desired tax treatment simply by proper drafting.”). [↑](#endnote-ref-73)
73. Reg. §§ 301.7701-1 to -3. [↑](#endnote-ref-74)
74. It took Treasury less than a year to realize the danger these rules posed to the effectiveness of the subpart F regime. *See* Treatment of Hybrid Arrangements Under Subpart F, I.R.S. Notice 98-11, 1998-1 C.B. 433 (announcing that “Treasury and the Service will issue regulations to address such arrangements, and requests public comments with respect to these subpart F issues”). The subsequently issued temporary and proposed regulations were withdrawn by Notice 98-35, accompanied by an announcement that Treasury intended to issue another set of proposed regulations on the treatment of hybrid branch arrangements. *See* I.R.S. Notice 98-35, 1998-1 C.B. 1325. However, no such regulations were ever issued. President Obama’s tax proposals initially included an ill-defined “limited legislative repeal of the check-the-box election for foreign entities for purposes of computing Subpart F income.” Sullivan & Cromwell LLP, Presidential Proposal on International Taxation 4 (May 4, 2009), <https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Presidential_Proposal_on_International_Taxation.pdf>. This proposal was never enacted, and, after Obama’s first Green Book, the proposal was dropped. [↑](#endnote-ref-75)
75. *See* Sicular, *supra* note 71, at 360 (“[W]hat the disregarded entity rules did is lead mechanically to the conclusion that the payments did not exist. Thus payments of locally deductible interest, rents and royalties, or indeed any movement of capital within the family of disregarded subsidiaries and their parent, disappeared completely from the U.S. tax radar screen….”). [↑](#endnote-ref-76)
76. *See id.* (“[I]t became possible for U.S. taxpayers to avoid completely subpart F inclusions arising from some intercompany payments within groups of its foreign subsidiaries.”). [↑](#endnote-ref-77)
77. For more detailed discussion of the use of hybrid entities to minimize foreign taxable income while avoiding subpart F treatment, including the structure that became known as the “Double Dutch Irish Sandwich,” see Edward D. Kleinbard, *Stateless Income*, 11 Fla. Tax Rev. 699, 711 (2011). Note that the particular example involves an escape from the foreign base company services income rules, but it worked as well for transactions which would otherwise generate foreign base company sales income. [↑](#endnote-ref-78)
78. *See supra* note 71. [↑](#endnote-ref-79)
79. Code Sec. 367 of the Code treats such transfers either as a realization event, which would generate large (taxable) gains for the U.S. parent or a constructive royalty arrangement, which would again generate a large and immediate income inclusion by the U.S. parent. *See* Code Sec. 367(d). Before 1997, it was even more difficult to transfer intangibles abroad than it is today. Specifically, Code Sec. 1491 provided that outbound transfers of intangibles to partnerships and trusts that were otherwise tax-free were subject to a 35 percent excise tax. The excise tax was also imposed on contributions of intangibles to foreign corporations, but only if made as contributions to capital or paid-in-surplus, that was not subjected to Code Sec. 367(d) by virtue of Code Sec. 367(c)(2). [↑](#endnote-ref-80)
80. *See* Ethan S. Kroll et al., *GILTI, FDII, and the Future of International IP Planning*, 96 Taxes 5 (May 2018). [↑](#endnote-ref-81)
81. David R. Tillinghast, *An Old-Timer’s Comment on Notice 98-11*, 16 Tax Notes Int’l 923 (Mar. 23, 1998). [↑](#endnote-ref-82)
82. *See* Tax Policy Study, *supra* note 20, at 48 (“If the foreign-to-foreign related party transactions reduced the tax rates in the high-tax foreign country by a large amount, however, then it becomes more likely that such transactions will worsen the global allocation of capital by attracting more capital from the United States than from the low-tax foreign country.”). [↑](#endnote-ref-83)
83. *Id*. at 51 n.72. [↑](#endnote-ref-84)
84. *See*, *e.g.*, Hearing on the Impact of International Tax Reform on U.S. Competitiveness Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means, 109th Cong. 5 (2006) (statement of R. Glenn Hubbard, Ph.D., Dean and Russell L. Carson Professor of Finance and Economics, Columbia Business School, New York, New York), <https://www.govinfo.gov/content/pkg/CHRG-109hhrg30706/pdf/CHRG-109hhrg30706.pdf> (“Like all firms, multinationals are faced with a number of business decisions, including how much to invest and where. Because multinationals by definition operate in a number of countries, they also have to decide in which country to locate their headquarters which in turn affects which countries reap the majority of benefits from the multinational's operations. Each of these business decisions is influenced by tax policy, particularly how countries tax income from foreign investment.”). [↑](#endnote-ref-85)
85. See Sean Bray, *Corporate Tax Rates around the World, 2021* (Dec. 9, 2021), <https://taxfoundation.org/publications/corporate-tax-rates-around-the-world/#Trends> (“Over the past 40 years, corporate tax rates have consistently declined on a global basis. In 1980, the unweighted average worldwide statutory tax rate was 40.11 percent. Today, the average statutory rate stands at 23.54 percent, representing a 41 percent reduction over the 41 years surveyed… The largest shift occurred between 2000 and 2010, with 78 percent of countries imposing a statutory rate below 30 percent in 2010 and only 47 percent of countries in the dataset imposing a statutory rate below 30 percent in 2000.”). [↑](#endnote-ref-86)
86. Indeed, the Tax Policy Study foreshadowed this policy change, noting that one potential step in remediating the U.S. international tax system would include retaining subpart F, but revoking what it called the “foreign-to-foreign related party rules,” including the rules treating payments between CFCs as foreign personal holding company income. Tax Policy Study, *supra* note 20, at 87. We discuss the various international tax policy options leading up to the enactment of GILTI in Part V.A, *infra*. [↑](#endnote-ref-87)
87. The provision sunsets on December 31, 2025. Code Sec. 954(c)(6)(C). [↑](#endnote-ref-88)
88. Foreign tax authorities, of course, might still object to such maneuvers. But their attacks would no longer be back-stopped by the IRS. [↑](#endnote-ref-89)
89. Perhaps most importantly, Code Sec. 954(c)(6) applied in situations in which check-the-box did not always work. *See* Sicular, *supra* note 71, at 362-64 (detailing limitations on check-the-box tax planning); *id.* at 366 (“[Code Sec. 954(c)(6)] will undoubtedly remedy many of the international tax planning pitfalls mentioned in the previous section.”). [↑](#endnote-ref-90)
90. Another way of putting it is that it is up to other countries to protect their own tax bases, if they desire to do so. If they do not, it is on them. And if they do not, if they allow the Nederlands of this world to strip earnings, then the Acmes (or their F Subs) should be allowed to compete on equal terms. [↑](#endnote-ref-91)
91. Code Sec. 954(b)(4) (election to exclude income from foreign base company income if subject to foreign tax of at least 90 percent of the Code Sec. 11 rate). [↑](#endnote-ref-92)
92. Source countries likely permitted tax reduction because they wanted the foreign investment more than the tax revenues, and feared that additional taxation would chase the investors away. *See* Mason, *supra* note 4, at 358 (“[S]ource states that allowed a lot of profit shifting presumably calculated that they preferred inbound investment and business activity to the additional revenue that strict tax enforcement would have generated.”). [↑](#endnote-ref-93)
93. *See* Members of the OECD/G20 Inclusive Framework on BEPS (2021), https://www.oecd.org/tax/beps/inclusive-framework-on-beps-composition.pdf. [↑](#endnote-ref-94)
94. The United States has also been justifiably concerned about uncoordinated increases in source taxation (or to put it another way, increases in source taxation without corresponding decreases in residence taxation claims), which could lead to double taxation. *See* Carol A. Dunahoo, *Source Country Taxation of Foreign Corporations: Evolving Permanent Establishment Concepts*, 86 Taxes 37, 54-55 (Mar. 2008) (“Any attempt to re-divide the international tax pie in the absence of a true consensus would likely substantially increase international double taxation….”). [↑](#endnote-ref-95)
95. Indeed, for many countries maintaining low effective corporate tax rates by statute or administrative practice, attracting investment was the point. *See* Mason, *supra* note 4, at 358. [↑](#endnote-ref-96)
96. *See* Mason, *supra* note 4,at 360 (“U.S. lawmakers became convinced that…foreign tax savings could help U.S. companies compete against companies headquartered elsewhere. In addition, lower foreign taxes for U.S. companies itself lowered the U.S. obligation to credit foreign taxes. This gave the United States both competitive and revenue reasons to turn a blind eye to U.S. multinationals’ foreign profit shifting.”). [↑](#endnote-ref-97)
97. For example, Treasury data suggests that $32 billion of revenue was collected with respect to foreign-source income in 2006—which amounted to less than 4 percent of all foreign source income of U.S. multinational entities. *See* Rosanne Altshuler et al., *Lessons the United States Can Learn From Other Countries’ Territorial Systems for Taxing Income of Multinational Corporations*, Tax Pol’y Center, Urban Instit. & Brookings Instit., Jan. 2015, at 21, <https://www.taxpolicycenter.org/publications/lessons-united-states-can-learn-other-countries-territorial-systems-taxing-income/full>. Other residence countries also failed to collect much tax from their multinationals. *See* Mason, *supra* note 4, at 358 (“But likewise catering to business interests and driven by competitive pressures, residence states also often did not tax.”). [↑](#endnote-ref-98)
98. *See* Dunahoo, *supra* note 933 (criticizing source countries’ efforts to increase taxation of U.S. multinationals). [↑](#endnote-ref-99)
99. As arguably the digital services taxes discussed in Part IV.C, *infra*, do. *See* Cong. Res. Service, Digital Services Taxes (DSTs): Policy and Economic Analysis 1 (2019), https://crsreports.congress.gov/product/pdf/R/R45532 (“Robert Stack, while Treasury Deputy Assistant Secretary for International Tax Affairs under President Obama, said that such efforts are primarily political efforts to target U.S. corporations.”); *infra* note 151 and accompanying text. [↑](#endnote-ref-100)
100. *See* Am. Law Inst., Federal Income Tax Project, International Aspects of United States Income Taxation II 150-51 (1991) (“[F]ollowing the United States lead, a number of other countries have begun to evidence an interest in the issue.”). Typically, such clauses were included in newly drafted treaties, or added as protocols to existing treaties. However, treaty renegotiations take a long time, and Congress was not averse to speeding things up by overriding treaties. For example, when it imposed the “branch profits tax” which replaces the withholding tax applicable to certain dividends paid by foreign corporations with U.S. branches with an extra layer of tax imposed directly on the profits of the U.S. branch, s*ee* Code Sec. 884(a) (imposing tax on “dividend equivalent amount”), it allowed this tax to be reduced to the rate applicable to dividends under a prevailing tax treaty only if and to the extent the taxpayer was a “qualified resident of the treaty partner.” *See* Code Sec. 884(e)(1)(B). And the definition of a “qualified resident” is found in the statute, not in the supposedly prevailing treaty. *See* Code Sec. 884(e)(4) (defining “qualified resident”). [↑](#endnote-ref-101)
101. *See* Am. Law Inst., *supra* note 99, at 151; H. David Rosenbloom, *Tax Treaty Abuse: Policy and Issues*, 15 L. & Pol’y in Int’l Bus. 763, 793 (1983). [↑](#endnote-ref-102)
102. Thomas Locher, *Thin-Cap Rules in Europe*, Tax Found. (July 15, 2021), <https://taxfoundation.org/thin-cap-rules-in-europe-2021/> (listing rules). [↑](#endnote-ref-103)
103. The United States’ first efforts with Code Sec. 163(j) (which arguably violated its treaty obligations), s*ee* Julie A. Roin, *Adding Insult to Injury: The “Enhancement” of § 163(j) and the Tax Treatment of Foreign Investors in the United States*, 49 Tax L. Rev. 269, 289 (1994) (“If Congress unilaterally revokes the benefits flowing from a treaty, as §163(j) indisputably would do whenever it applies, it essentially is reneging on that bargain.”), pre-dated the BEPS era. The current version of the interest deduction limitation was enacted after BEPS issued its recommendations for limiting interest deductions, and adheres to the pattern recommended in BEPS 1.0 Action 4. It could thus be described as both a pre-BEPS and post-BEPS change in law. [↑](#endnote-ref-104)
104. Code Sec. 163(j). [↑](#endnote-ref-105)
105. However, any disallowed interest expense can be carried over and used to offset income in a later year if it can do so within the section 163(j) limits for that subsequent year. Code Sec. 163(j)(2) (carryover rule). These restrictions have been extended to CFCs, but taxpayers are allowed to elect to aggregate the CFC group for these purposes. [↑](#endnote-ref-106)
106. *See* Sebastian Duenas, *CFC Rules Around the World*, Tax Found. (June 17, 2019), <https://taxfoundation.org/cfc-rules-around-the-world/>. [↑](#endnote-ref-107)
107. Ruth Mason ascribes the change to the financial crisis of 2008. *See* Mason, *supra* note 4, at 355. [↑](#endnote-ref-108)
108. OECD, Harmful Tax Competition: An Emerging Global Issue (1998), [www.oecd.org/ctp/harmful/1904176.pdf](http://www.oecd.org/ctp/harmful/1904176.pdf). [↑](#endnote-ref-109)
109. *Id*. at 8. [↑](#endnote-ref-110)
110. The U.S. Senate’s Permanent Subcommittee on Investigations held hearings on corporate tax avoidance in 2012, and the UK Parliament held hearings in 2013. *See* Mason, *supra* note 4, at 364-65. [↑](#endnote-ref-111)
111. *See id.* at 366. [↑](#endnote-ref-112)
112. *See* Stewart Lipeles et al., *Understanding the Real-World Consequences of Pillar II*, 100 Taxes 9, 12 (Sept. 2022) (“The BEPS Project sought to address domestic and treaty law gaps that allowed for what was variously termed stateless income, nowhere-taxed income, and double non-taxation.”). [↑](#endnote-ref-113)
113. *See supra* PartIII.A.2. [↑](#endnote-ref-114)
114. *BEPS Actions*, OECD, https://www.oecd.org/tax/beps/beps-actions/ (describing 15 actions that the OECD/BEPS Project set forth to “equip governments with domestic and international rules and instruments to address tax avoidance,” including BEPS action 2 “Neutralising the effects of hybrid mismatch arrangements” and action 3 “Controlled Foreign Company”); OECD/G20 Base Erosion and Profit Shifting Project, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (2015*)*, http://dx.doi.org/10.1787/9789264241138-en. [↑](#endnote-ref-115)
115. The U.S. rules are found in Code Secs. 245A and 267A; they withdraw benefits otherwise available to foreign entities under U.S. tax treaties. [↑](#endnote-ref-116)
116. The EU Council issued a directive requiring its member nations to enact anti-hybrid provisions by January, 2020. *See The Anti Tax Avoidance Directive*, European Comm’n, <https://taxation-customs.ec.europa.eu/anti-tax-avoidance-directive_en> (describing “five legally-binding anti-abuse measures, which all Member States should apply against common forms of aggressive tax planning”). The last anti-hybrid provision, targeting the “reverse hybrid mismatch” went into force in January, 2022. *See* Dechert LLP, *ATAD2—Reverse Hybrid Provisions Enter into Force 1 January 2022: What To Do Before Year End!*, JD Supra (Dec. 7, 2021), <https://www.jdsupra.com/legalnews/atad2-reverse-hybrid-provisions-enter-1808880>. [↑](#endnote-ref-117)
117. Mindy Herzfeld, *News Analysis: Will Effective Tax Rates Converge?*, 89 Tax Notes Int’l 389 (Jan. 29, 2018) (“Those structures are likely no longer sustainable because several global tax trends are pressuring them in different ways.”). [↑](#endnote-ref-118)
118. 2016 U.S. Model Treaty, *supra* note 26, at Art. 7.1. To have a permanent establishment, a taxpayer must have a physical location in the treaty country through which activities other than those of a “preparatory or auxiliary” nature are conducted. *See id.* at Art. 5.1. Some activities, including the “storage, display, or delivery of goods” or “the maintenance of a stock of goods…solely for the purpose of storage, display, or delivery,” the “collection of information” and “purchasing” are explicitly disregarded for purposes of establishing a permanent establishment. *See id.* at Art. 5.4. The performance of actual sales activities—or manufacturing activities—in a physical location located within a country, though, generally leads to permanent establishment status. [↑](#endnote-ref-119)
119. The activities (and offices) of independent agents “acting in the ordinary course of their business as independent agents” are not considered to be those of their principal. *See* 2016 U.S. Model Tax Treaty, Art. 5.6. [↑](#endnote-ref-120)
120. *See id.* at Art.5.7 (“The fact that a company that is a resident of a Contracting State controls or is controlled by a company that is a resident of the other Contracting State, or that carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not be taken into account in determining whether either company has a permanent establishment in that other Contracting State.”). [↑](#endnote-ref-121)
121. *See id.* at Art. 5.5 (permanent establishment created where a person “acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts in the name of the enterprise”). [↑](#endnote-ref-122)
122. *See* Jean Pierre Le Gall, *Can a Subsidiary Be a Permanent Establishment of its Foreign Parent? Commentary on Article 5, par. 7 of the OECD Model Tax Convention*, 60 Tax L. Rev. 179, 193-99 (2007) (discussing cases). [↑](#endnote-ref-123)
123. *See* Dunahoo, *supra* note 93, at 41 (“As a practical matter, the effects of the proposed provision may not be limited to future treaties in which it is included.”). [↑](#endnote-ref-124)
124. In 2006, several countries pressed a proposal to change the Commentary on Article 5 of the OECD Model Treaty to add an “alternative treaty provision” for use by countries seeking to “impose taxation at source on income from the performance of cross-border services without a fixed place of business or contract-concluding dependent agent.” *See* Dunahoo, *supra* note 93, at 39 (describing proposed changes). The proposed “alternative treaty provision” would have deemed taxpayers to have a permanent establishment in a treaty partner’s country whenever they had an agent providing services in that country for 183 days or more during the taxable year, completely eliminating the need for a physical establishment in the services context. *See id.* In addition, in 2011, the OECD Working Group proposed amending the Commentary to its Model Treaty to provide that “the phrase ‘authority to conclude contracts in the name of the enterprise’ does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.” The proposed amendment was not accepted. Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (Oct. 12, 2011 - Feb. 10, 2021), available at https://www.oecd.org/tax/treaties/49782184.pdf. [↑](#endnote-ref-125)
125. *Action 7 Permanent Establishment Status*, OECD, <https://www.oecd.org/tax/beps/beps-actions/action7/>. [↑](#endnote-ref-126)
126. OECD, Model Tax Convention on Income and on Capital 2017 (Full Version) (2019), <https://www.oecd.org/tax/model-tax-convention-on-income-and-on-capital-full-version-9a5b369e-en.htm> [hereinafter OECD 2017 Model Tax Convention]. [↑](#endnote-ref-127)
127. *Id*. at Art. 5.5. [↑](#endnote-ref-128)
128. *See id.* atCommentaries on the Articles of the Model Tax Convention, Commentary on Article 5, Concerning the Definition of Permanent Establishment ¶¶12-19. [↑](#endnote-ref-129)
129. *Id*. at ¶¶3-4. [↑](#endnote-ref-130)
130. *Id.* at ¶187. [↑](#endnote-ref-131)
131. *See, e.g.*, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, at Art. 4.3 (2016) (“A Party may reserve the right: a) for the entirety of this Article not to apply to its Covered Tax Agreements….”) [hereinafter Multilateral Convention]. [↑](#endnote-ref-132)
132. *See id.* at 1 (“Recognising the need for an effective mechanism to implement agreed changes…without the need to bilaterally renegotiate each such agreement….”); Mason, *supra* note 4,at 373-74 (describing MLI treaty updating process). [↑](#endnote-ref-133)
133. Multilateral Convention, *supra* note 121, at 1 (“Conscious of the need to ensure swift, co-ordinated and consistent implementation of the treaty-related BEPS measures in a multilateral context….”). [↑](#endnote-ref-134)
134. OECD/G20 Base Erosion and Profit Shifting Project, Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10: 2015 Final Reports (2015), https://www.oecd.org/ctp/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm. [↑](#endnote-ref-135)
135. Note that this requirement of actual involvement in the income producing activities is analogous to the contract manufacturing regulation’s requirement that F Sub’s employees be involved in the manufacturing process. [↑](#endnote-ref-136)
136. *See, e.g.*, Mindy Herzfeld, *The Case Against BEPS: Lessons for Tax Coordination*, 21 Fla. Tax Rev. 1, 32 (“But value creation is an incoherent and ill-defined notion….”); Brian Cody et al., *Transfer Pricing’s Brave New World*, 166 Tax Notes 583, 584 (Jan. 27, 2020) (“The new standard is not well defined…[and] it varies from country to country.”). [↑](#endnote-ref-137)
137. *See* Herzfeld, *supra* note 135, at 52 (“The resulting rules leave themselves open to multiple interpretation by both taxpayers and administrators, opening the door to even more aggressive planning and numerous cross-border disputes, as well as an abandonment of the rule of law by tax administrators.”). [↑](#endnote-ref-138)
138. *See* Sean Foley & Cristian Faundez, *OECD DEMPE and Risk Guidance in the US*, Tax Adviser (June 1, 2022), <https://www.thetaxadviser.com/issues/2022/jun/oecd-dempe-risk-guidance-us.html> (“Several countries around the world have expressly incorporated the DEMPE concept and its analytical framework into their own domestic law, but that is not the case for the United States.”). [↑](#endnote-ref-139)
139. *See* Mason, *supra* note 4, at 371. [↑](#endnote-ref-140)
140. *Action 12 Mandatory Disclosure Rules*, OECD, <https://www.oecd.org/tax/beps/beps-actions/action12/>. [↑](#endnote-ref-141)
141. *See* Mason, *supra* note 4,at 371. [↑](#endnote-ref-142)
142. *See Action 13 Country-by-Country Reporting*, OECD, <https://www.oecd.org/tax/beps/beps-actions/action13>. [↑](#endnote-ref-143)
143. Mason, *supra* note 4, at 371. [↑](#endnote-ref-144)
144. *See*, *e.g.*, Baker & McKenzie LLP, Comments on the Public Discussion Draft on BEPS Action 1: Address the Tax Challenges of the Digital Economy, <https://www.oecd.org/ctp/comments-action-1-tax-challenges-digital-economy.pdf> (Apr. 13, 2014) (“It is a common misperception that digital economy enterprises as a general matter are able to operate with significantly fewer personnel than other enterprises. For most digital / internet companies, the ability to scale is not attributable to an ability to carry on economic activity with minimal need for personnel to be present, although there are certainly some digital / internet companies, principally some in their start-up phase, for which this statement is true.”); Business and Industry Advisory Committee to the OECD (“BIAC”), Comments on OECD Discussion Draft on BEPS Action Item 1 – Address the Tax Challenges of the Digital Economy, *id* (Apr. 14, 2014) (“BIAC nevertheless acknowledges that [information and communications technology] enables enterprises to centralize certain functions, such as finance, legal, management, and customer support functions, in a single location to reduce costs and improve efficiency. This location might (or might not) be remote from market jurisdictions. By definition, centralizing such functions means that the centralized activity will be remote from the majority of market jurisdictions. Centralizing functions does not entail the mobility of functions, however. Instead, centralizing functions requires that these functions remain fixed at a single location. Current transfer pricing rules can be used to address the issue of mobility with respect to services that are used internally.”). [↑](#endnote-ref-145)
145. *See*, *e.g.*, United States Council for International Business, USCIB Response to the OECD’s Discussion Draft on the Tax Challenges of the Digital Economy (the Discussion Draft), *id.* (Apr. 11, 2014) (“[T]he Discussion Draft overstates concerns about the mobility of intangible assets, users, and business functions in the digital economy. Enterprises in all areas of the economy, including pharmaceutical, biotechnology, semiconductor, and natural resources enterprises, develop, acquire, and exploit intangible assets.”); BIAC, *supra* note 143 (“In its treatment of the mobility of business functions, the Discussion Draft suggests that digital/internet companies are able to ‘carry on economic activity with minimal need for personnel to be present.’ (Para. 98) BIAC respectfully disagrees with this contention. BIAC observes that all enterprises, including digital/internet companies, require human resources to scale, as evidenced by the tens of thousands of employees of the leading digital/internet companies.”). [↑](#endnote-ref-146)
146. *See*, *e.g.*, Lipeles et al, *supra* note 111, at 13 (“Despite the apparent success of the BEPS Project in both changing the architecture of international tax and adjusting corporate behavior, some jurisdictions concluded that the BEPS actions were nevertheless insufficient to address specific challenges posed by the Internet and the digital economy. These jurisdictions, starting with India, France, Italy, Turkey, and the UK, began to unilaterally start taxing he gross revenue MNEs generate from providing digital services to customers.”). About half of the European nations have imposed digital services taxes, as have a number of non-European nations. *See* Elke Asen & Daniel Bunn, *What European OECD Countries Are Doing About Digital Services Taxes*, Tax Found. (Nov. 22, 2021), <https://taxfoundation.org/digital-tax-europe-2020/> (listing taxes); Gordon Gray & Jennifer Huddleston, *Digital Services Taxes: A Primer*, Am. Action Forum: Insight (Mar. 25, 2021), <https://www.americanactionforum.org/insight/digital-services-taxes-a-primer/> (26 nations have digital services taxes and another 15 have proposed them); Amie Ahanchian et al., *Digital Services Tax: Why the World Is Watching*, Bloomberg Tax (Jan. 6, 2021), <https://news.bloombergtax.com/daily-tax-report/digital-services-tax-why-the-world-is-watching> (table of digital services taxes). [↑](#endnote-ref-147)
147. For example, in 2018, the European Commission proposed a temporary digital services tax that would have been imposed on businesses with annual worldwide revenues exceeding $915 million and taxable revenues exceeding $61 million. *See* Ahanchian et al., *supra* note 145. Although that particular proposal was not accepted, many EU nations adopted similar—though far from identical—taxes. *See supra* note 145. [↑](#endnote-ref-148)
148. Katherine E. Karnosh, Comment, *The Application of International Tax Treaties to Digital Services Taxes*, 21 Chi. J. Int’l L. 513, 519 (2021), <https://chicagounbound.uchicago.edu/cjil/vol21/iss2/8> (explaining that the French DST falls outside the scope of bilateral tax treaties because it is a “consumption tax on revenues” rather than an “income tax on profits” and thus does not contravene their “permanent establishment” requirements); Christoph Jescheck, *Debate: Taxes on Digital Services and the Substantive Scope of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model*, 46 Intertax 573, 573 (2018) (describing how DST taxes “can be seen as either explicit treaty overrides or, more interestingly, falling outside the scope of existing tax treaties”). [↑](#endnote-ref-149)
149. Indeed, Treasury issued regulations aimed at ensuring this result. *See* Guidance Related to the Foreign Tax Credit; Clarification of Foreign-Derived Intangible Income, 87 Fed. Reg. 276, 282 (Jan. 4, 2022) (replacing the “jurisdictional nexus” requirement of the proposed regulations). [↑](#endnote-ref-150)
150. Since such taxes are a purely a function of sale receipts, if taxpayer have pricing power, they can shift the burden of the tax onto consumers by raising their sale prices by the amount of the tax. There is some evidence that this has happened. *See* Ahanchian et al., *supra* note 145 (“Several companies have already announced that they would increase their prices because of these DSTs….”). [↑](#endnote-ref-151)
151. *See* Gray & Huddleston, *supra* note 145 (discussing how Amazon raised its fees for third-party sellers after France’s adoption of a DST). [↑](#endnote-ref-152)
152. Indeed, the United States regards such taxes as a form of illegal discrimination against U.S. companies, and authorized (but not imposed) retaliatory tariffs against several countries maintaining such a tax. *See* Ahanchian et al., *supra* note 145 (describing trade retaliation); Gray & Huddleston, *supra* note 145 (same); Press Release, Remarks by Assistant Secretary for Tax Policy Lily Batchelder on Global Corporate Tax at the Hutchins Center at Brookings Institute and the Urban-Brookings Tax Policy Center (Apr. 15, 2022), https://home.treasury.gov/news/press-releases/jy0717 (“At the same time, political pressures abroad began creating a chaotic array of digital services taxes and other unilateral measures. These taxes often discriminated against US businesses.”); Peter Glicklich & Heath Martin, *Not Whether But When and How: U.S. Response to Unilateral Digital Taxation*, Bloomberg Tax (Oct. 30, 2019), <https://news.bloombergtax.com/daily-tax-report-international/not-whether-but-when-and-how-u-s-response-to-unilateral-digital-taxation> (“For instance, the fact that DSTs tend to discriminate against a handful of U.S. companies, or the fact that many DSTs are being proposed retroactively, could form the basis of a challenge in front of the World Trade Organization or under other trade agreements.”); U.S. Trade Rep., Section 301 Investigation Report on France’s Digital Services Tax 11 (2019), <https://ustr.gov/sites/default/files/Report_On_France%27s_Digital_Services_Tax.pdf> (“The vast majority of the written comments and all the hearing testimony supported the section 301 investigation and provided evidence and argumentation supporting one or more of the three bases of the investigation outlined in the Initiation Notice. Comments and hearing testimony argued that the DST discriminates against U.S. companies….”); Comment from Gary Sprague, Section 301 on France’s Digital Services Tax, USTR-2019-0009-0009 (Aug. 8, 2019), https://www.regulations.gov/comment/USTR-2019-0009-0009 (“Facially neutral, the DST’s scope and turnover thresholds are crafted to capture principally successful US companies. To that end, the DST includes services provided by US companies (e.g., digital advertising), but excludes ‘like’ services of European firms (e.g., internet of things), and sets a conveniently high turnover threshold.”). [↑](#endnote-ref-153)
153. *See* Asen & Bunn, *supra* note 145 (“On October 21, a joint statement from Austria, France, Italy, Spain, the United Kingdom, and the United States laid out a plan to roll back digital services taxes (DSTs) and retaliatory tariff threats once the Pillar 1 rules are implemented. On November 22, the U.S. Treasury announced that Turkey had agreed to the same terms.”). [↑](#endnote-ref-154)
154. It is not entirely clear why it had this effect; after all, as laid out *supra* note 149, the burden of these taxes may not fall on U.S. multinationals. [↑](#endnote-ref-155)
155. Pascal Saint-Amans, Tax Reform: Tax Havens, Base Erosion and Profit Shifting, Hearing Before the Committee on Ways and Means, U.S. House of Representatives, One Hundred Thirteenth Congress (June 13, 2013), <https://www.govinfo.gov/content/pkg/CHRG-113hhrg21122/html/CHRG-113hhrg21122.htm> (“Tax work at the OECD focuses primarily on eliminating double taxation. As you know, when you have cross-border investments, they can be taxed at source, in the country where the operations are taking place, but also at residence, where the headquarters of the international company is based. As a result you may have tax at source and at residence. And this is no good for cross-border investments, which all countries need in a free trade environment to foster growth and to foster jobs. And for the case, we have been working on eliminating double taxation by providing a Model Tax Convention on which countries draw when they negotiate bilateral treaties, as the U.S. is doing…. What has happened over the past few years, I would say three to four years, is a growing concern in all OECD countries—and this goes beyond OECD countries to include what we call the BRISC—Brazil, Russia, India, South Africa, China, and some others—about what we now call base erosion and profit shifting. That is why the OECD was asked by its member countries to launch this project on BEPS to put an end to what countries identify as double nontaxation.”). [↑](#endnote-ref-156)
156. *See* Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note (Jan. 23, 2019), <https://www.oecd.org/tax/beps/policy-note-beps-inclusive-framework-addressing-tax-challenges-digitalisation.pdf> (“The Action 1 Report also observed that, beyond BEPS, the digitalisation of the economy raised a number of broader direct tax challenges chiefly relating to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries.”). [↑](#endnote-ref-157)
157. *See* OECD, International Community Strikes a Ground-Breaking Tax Deal for the Digital Age (Oct. 8, 2021), <https://www.oecd.org/tax/international-community-strikes-a-ground-breaking-tax-deal-for-the-digital-age.htm> (“Four countries - Kenya, Nigeria, Pakistan and Sri Lanka - have not yet joined the agreement.”). [↑](#endnote-ref-158)
158. OECD/G20 Base Erosion and Profit Shifting Project, Progress Report on Amount A of Pillar One, Two-Pillar Solution to the Tax Challenges of the Digitalization of the Economy 8 (2022), <https://www.oecd.org/tax/beps/progress-report-on-amount-a-of-pillar-one-july-2022.pdf>. A “Covered Group” is any group of related companies whose joint revenue exceeds €20 billion within a twelve-month period, and whose pre-tax profit margin is greater than 10 percent. *See id.* at 10 (Art. 1). [↑](#endnote-ref-159)
159. *See id.* at 11. [↑](#endnote-ref-160)
160. *See id.* at 14 (Art. 3.1). The requisite amount is reduced to €250,000 for jurisdictions with a yearly gross domestic product of less than €40 billion. *See id.* at 14 (Art. 3.2). It contains quite elaborate rules for determining where income is derived for purposes of applying these rules. *See id.* at 13-15 (Art. 4: Revenue Sourcing Rules). [↑](#endnote-ref-161)
161. *See id.* at 16 (Art. 6: Allocation of profit). [↑](#endnote-ref-162)
162. *See id.* at 18-21 (Title 5: Elimination of double taxation with respect to Amount A). Essentially, it applies a “waterfall” approach, which deducts profits reallocated to another country from the jurisdiction or subsidiary showing the highest profit margin; when that profit margin is reduced to the level of other entities or jurisdictions, further reallocations come at the expense of entity/jurisdiction with the next highest profit margin. *See* EY, OECD releases Progress Report on Amount A of Pillar One of BEPS 2.0 Project: A detailed overview, July 15, 2022, at <https://globaltaxnews.ey.com/news/2022-5668-oecd-releases-progress-report-on-amount-a-of-pillar-one-of-beps-20-project-a-detailed-overview> (describing “waterfall approach”). [↑](#endnote-ref-163)
163. *See* Alistair Pepper et al., *Amount B: The Forgotten Piece Of the Pillar 1 Jigsaw*, 107 Tax Notes Int’l 143, 144 (July 11, 2022), <https://tax.kpmg.us/content/dam/tax/en/pdfs/2022/pillar-1-amount-b-tni-071122.pdf> (“[T]here is no suggestion that amount B would be limited to businesses based on a revenue or profitability threshold….”). [↑](#endnote-ref-164)
164. *See* Phillippe G. Penelle, *An Article 9 Analysis of the OECD’s Pillar One Amount B*, Bloomberg Tax (July 22, 2022), <https://news.bloombergtax.com/tax-insights-and-commentary/an-article-9-analysis-of-the-oecds-pillar-one-amount-b>. If a jurisdiction is entitled to both an Amount A and an Amount B allocation, it is allowed to tax only the larger of the two amounts. *See* Michael Lebovitz et al., *OECD Takes Important Steps in Advancing Pillar One, Progress Noted on Pillar Two*, Mayer Brown (Feb. 7, 2020), <https://www.mayerbrown.com/en/perspectives-events/publications/2020/02/taxing-the-digital-economy>. [↑](#endnote-ref-165)
165. *See* Penelle, *supra* note 163.However, the impetus behind Amount B may be less the expansion of nexus and more the difficulty of countries with nexus in determining the appropriate income allocations for these activities. The original idea was to come up with a uniform profit margin calculated with respect to sales—but variations among industries and functions make achieving such simplicity unlikely. *See* Pepper et al., *supra* note 162, at 145 (discussing disputes). [↑](#endnote-ref-166)
166. *See* Pepper et al., *supra* note 162, at 145; Scott Stewart, *OECD’s Pillar One Blueprint: Amount B*, Mayer Brown (May 7, 2021), <https://www.bestmethodsblog.com/2021/05/oecds-pillar-one-blueprint-amount-b/>. [↑](#endnote-ref-167)
167. U.S. Bureau of Econ. Analysis, Direct Investment by Country and Industry for 2021, at 3 (2022), <https://apps.bea.gov/scb/2022/08-august/pdf/0822-direct-investment.pdf> (“In 2021, U.S. multinationals earned $542.3 billion on their investments abroad…, up 25.0 percent from the $433.7 billion earned in 2020.”); *see also* Richard Rubin & Theo Francis, *U.S. Companies Brought Back Foreign Profits as Coronavirus Struck*, Wall St. J. (June 19, 2020), <https://www.wsj.com/articles/u-s-companies-brought-back-foreign-profits-as-coronavirus-struck-11592574620> (providing that in the first quarter of 2020, “U.S. companies made $115 billion in foreign profits in the first quarter and brought $124 billion back to the U.S.”). After the TCJA, in 2018, “U.S. multinationals repatriated a record $853.4 billion from their foreign affiliates.” U.S. Bureau of Econ. Analysis, *supra*, at 6; *see also* Bloomberg, *U.S. Companies Have Repatriated $1 Trillion Since Tax Overhaul*, LA Times (Dec. 19, 2019), <https://www.latimes.com/business/story/2019-12-19/companies-repatriate-1-trillion-since-tax-overhaul> (“Corporations have brought back more than $1 trillion of overseas profits to the U.S. since Congress overhauled the international tax system and prodded companies to repatriate offshore funds, a Thursday report showed.”). Repatriation decreased but remained higher than normal through 2019 and 2020. In 2020, U.S. multinationals repatriated $299.1 billion. U.S. Bureau of Econ. Analysis, *supra*, at 6. In 2021, repatriation returned to more normal levels with U.S. multinationals repatriating $233.9 billion. *Id.* [↑](#endnote-ref-168)
168. Tax Policy Study, *supra* note 20, at 98. [↑](#endnote-ref-169)
169. *Id.* at 81. [↑](#endnote-ref-170)
170. Press Release, Senate Finance Committee, Hatch Opening Statement at Finance Committee Hearing on International Tax Reform (Oct. 3, 2017) (“According to the Joint Committee on Taxation, American companies are currently holding more than $2.6 trillion in earnings offshore, thanks, in large part, to our worldwide tax system—something often referred to as the ‘lock-out’ effect. That’s $2.6 trillion held by foreign subsidiaries of U.S. corporations that the parent companies are unable to invest here at home. That is income that could be used to create more American jobs and grow wages for American workers. And, that income has attracted the interests of foreign tax authorities, particularly in Europe, who wish to tap into what is, by all rights, part of the U.S. tax base.”); EY, Buying and Selling: Cross-Border Mergers and Acquisitions, and the US Corporate Income Tax 10 (2017) (“The combination of a high corporate income tax rate and a worldwide system puts US companies at a competitive disadvantage in the market for cross border M&A. Businesses incorporated in countries with a territorial tax system face host country tax rates on their activity located in those countries but almost no additional tax in their home country. If those businesses were instead incorporated in the United States, they would pay additional tax on repatriated foreign earnings. The result is an economic disincentive for US ownership of corporate assets.”); Kyle Pomerlau & Kari Jahnsen, Tax Foundation, Designing a Territorial Tax System: A Review of OECD Systems 2 (2017) (“In some cases, the system incentivizes companies to avoid the domestic tax on their foreign profits by moving their corporate headquarters out of the United States. As a result, the U.S. worldwide system has been one of the major drivers of corporate inversions in the last few decades.”). [↑](#endnote-ref-171)
171. *See* Robert J. Peroni et al., *Getting Serious about Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. Rev. 455, 508-9 (1999) (“[A] a more effective method for ending deferral would be to treat each U.S. person (including a U.S. multinational corporation) owning stock in a foreign corporation (regardless of whether the foreign corporation is a CFC as defined in section 957) as if that shareholder directly earned his, her, or its pro rata share of the foreign corporation’s gross income and expenses.”). [↑](#endnote-ref-172)
172. *See* Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations*, 54 Nat’l Tax J. 771, 772 (2002); Hugh J. Ault, *U.S. Exemption/Territorial System vs. Credit Based System*, 32 Tax Notes Int’l 725 (Nov. 24, 2003). Even those leaning more toward the full inclusion side of the policy argument weighed in on how to design a sensible participation exemption system. *See, e.g.*, J. Clifton Fleming et al., *Designing a U.S. Exemption System for Foreign Income When the Treasury Is Empty*, 13 Fla. Tax Rev*.* 397 (2013). [↑](#endnote-ref-173)
173. Tax Policy Study, *supra* note 20, at 87 n.6. The report added a drop of realism to its brief treatment of territoriality, noting that even countries with exemption systems have only partial, not “pure,” exemption systems, and thus “an exemption system is not necessarily an alternative to the implementation of an anti-deferral regime.” *Id.* [↑](#endnote-ref-174)
174. *Id.* at 87 n.7. Foreign-to-foreign related party rules meant “(a) the subpart F rules that treat as foreign personal holding company income passive income items received from a related corporation without application of section 954(c)(6) (which did not exist at the time of the Tax Policy Study), (b) the foreign base company services income rules, and (c) the foreign base company sales income rules.” *Id.* at 42. [↑](#endnote-ref-175)
175. *Id.* at 93. “It is unlikely, however, that this option would significantly promote the goal of simplicity. The current subpart F regime is complicated, and retaining much of the current regime would mean retaining much of its complexity. Although elimination of the foreign-to-foreign related party rules could eliminate some complexity, calculating an effective tax rate could add complexity.” *Id.* [↑](#endnote-ref-176)
176. *See*, *e.g.*, Nicholas J. DeNovio and Jason Choi, *Solving the Lockout Effect*, 89 Taxes 39, 40 (Mar. 2011) (“The Lockout Effect is the term for the factors which have conspired to result in U.S.-based multinationals having nearly $1 trillion in deferred overseas earnings. Depending on one’s point of view, this effect is either (i) the product of a distorted tax system which provides a privilege to foreign income which is unavailable to, for example, the manufacturer in Buffalo or the hardware store owner in Madison, or (ii) the product of a punitive, outdated system which taxes worldwide income in a manner becoming more isolated as compared to the rest of the world at the same time that the alleviation of a worldwide double tax burden is becoming less available due to the ever shrinking foreign tax credit.”). [↑](#endnote-ref-177)
177. Tillinghast, *supra* note 80, at 924; David R. Tillinghast, *Taxation of Electronic Commerce: Federal Income Tax Issues in the Establishment of a Software Operation in a Tax Haven*, 4 Fla. Tax Rev. 339, 362 (1999). [↑](#endnote-ref-178)
178. U.S. Dep’t of Treasury, General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals (2009) [hereinafter the Green Book], <https://home.treasury.gov/system/files/131/General-Explanations-FY2010.pdf>. [↑](#endnote-ref-179)
179. First, the Green Book proposed limiting U.S. parent corporations’ ability to benefit from certain deductions were related to deferred foreign income, prior to the associated income’s repatriation. As some observed, this policy would have been tantamount to a full inclusion regime for some taxpayers. Second, the administration proposed calculating the deemed paid foreign tax credit with respect to repatriated earnings on a CFC-wide basis. In other words, taxpayers would no longer be able to concentrate pools of “hyped” foreign tax credits in particular CFCs, and would instead be forced to blend their foreign tax and E&P pools across all of their CFCs. Third, the Green Book called for the codification of Notice 98-11, *see supra* note 735, by making a check-the-box election for disregarded entity classification available only where the electing entity was organized in the same jurisdiction as its regarded owner. This was intended to prevent the use of check-the-box elections from base eroding high tax jurisdictions. [↑](#endnote-ref-180)
180. H.R. 4872, Pub. L. No. 111-152, 111th Cong. (Mar. 30, 2010). [↑](#endnote-ref-181)
181. For more in-depth explorations of the various proposals leading up to the enactment of GILTI in the Tax Cuts and Jobs Act, see Dana L. Trier, *International Tax Reform in a Second Best World: The GILTI Rules*, 97 Taxes 39 (Mar. 2019); Christopher H. Hanna et al., *The Rise of the Minimum Tax*, 100 Taxes 55 (Mar. 2022). [↑](#endnote-ref-182)
182. Under Camp’s Option A, upon a U.S. person’s transfer of intangible property from the United States to a CFC, that U.S. person would be required to include currently the related “excess income” as a new category of subpart F income, to the extent that income was neither earned in same-country transactions nor subject to a minimum 15 percent effective rate of foreign income tax. Camp’s Option A echoed the Obama proposal to “Tax Currently Excess Returns Associated with Transfers of Intangibles Offshore,” which first appeared in the administration’s revenue proposals for the 2012 fiscal year. U.S. Dep’t of Treasury, General Explanations of the Administration’s Fiscal Year 2012 Revenue Proposals 43 (2011), <https://home.treasury.gov/system/files/131/General-Explanations-FY2012.pdf>. Camp’s Option B required a subpart F inclusion for CFC income that was neither from an active business in the CFC’s jurisdiction nor subject to less than a 10 percent effective foreign tax rate. Option C created “foreign base company intangible income” (“FBCII”) as a new category of subpart F income. This included any gross income of the CFC derived from the direct or indirect use of intangible property. FBCII was subject to a reduced U.S. tax rate of 15 percent. “Foreign intangible income” that the U.S. parent earned from markets outside the United States likewise was eligible for the 15 percent effective U.S. tax rate. [↑](#endnote-ref-183)
183. President Obama’s 2012 Framework for Business Tax Reform reflected concepts similar to those in the Camp bill, proposing that “foreign income deferred in a low-tax jurisdiction would be subject to immediate U.S. taxation up to the minimum tax rate with a foreign tax credit allowed for income taxes on that income paid to the host country.” White House & U.S. Dep’t of Treasury, The President’s Framework for Business Tax Reform 14 (2012), <https://home.treasury.gov/system/files/131/OTA-Report-Business-Tax-Reform-2012.pdf>. At about the same time as the Obama Framework, Senator Michael Enzi released another proposal for a 95 percent participation exemption with a companion anti-base erosion measure in the form of a minimum tax on foreign earnings. The Enzi proposal eliminated foreign base company sales and services income and instead applied a foreign effective tax rate threshold to cause income that was not “qualified business income” to be subpart F income. A CFC’s foreign intangible income was per se non-qualified business income, and a separate section 904 foreign tax credit limitation applied to foreign intangible income. Later in 2012, Senator Max Baucus chipped in his own proposal with Options Y and Z, both of which would repeal check-the-box and section 954(c)(6) and would retain subpart F as an anti-base erosion measure to achieve a minimum tax. [↑](#endnote-ref-184)
184. Harry Grubert & Rosanne Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 Nat’l Tax. J. 671 (2013). [↑](#endnote-ref-185)
185. See *supra* note 181 (describing FBCII). [↑](#endnote-ref-186)
186. Starting with the 2016 fiscal year, the previous proposal for a tax on “excess returns” was converted to a 19 percent minimum tax on foreign income (assuming a 28 percent top line corporate rate) with an 85 percent foreign tax credit. The proposed minimum tax had an analog to the QBAI carve-out in the form of an “allowance for corporate equity.” U.S. Dep’t of Treasury, General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals 11 (2016), <https://home.treasury.gov/system/files/131/General-Explanations-FY2017.pdf> (“The tentative minimum tax base would be reduced by an allowance for corporate equity (ACE). The ACE allowance would provide a risk-free return on equity invested in active assets, which generally would include assets that do not generate foreign personal holding company income (determined without regard to both the look-through rule of section 954(c)(6) and any election to disregard an entity as separate from its owner). Thus, the ACE allowance is intended to exempt from the minimum tax a return on the actual activities undertaken in a foreign country.”). [↑](#endnote-ref-187)
187. The section 250 deduction for GILTI declines to 37.5 percent in 2026. Code Sec. 250(a)(3). [↑](#endnote-ref-188)
188. The section 250 deduction for FDII is 37.5 percent and is set to go down to 21.875 percent for tax years beginning after December 31, 2025. To the extent GILTI and FDII, in total, exceed the domestic corporation’s taxable income, however, the section 250 deduction becomes unavailable. Code Sec. 250(a)(2). In other words, NOLs first reduce FDII, and then GILTI, that would be eligible for the section 250 deduction. This is a punitive result because the NOL generally would reduce income otherwise taxable at an effective rate of 21 percent, but under this rule the NOL must first offset income subject to tax at an effective rate of only 13.125 percent, dramatically reducing the value of that tax attribute. [↑](#endnote-ref-189)
189. H.R. Rep No. 115-409, at 388 (2017). [↑](#endnote-ref-190)
190. U.S. Senate Budget Committee, Explanation of the Bill 365 (2017) (providing an explanation of the Tax Cuts and Jobs Act, as passed by the Senate Finance Committee). [↑](#endnote-ref-191)
191. To be covered by Pillar Two, a multinational enterprise must derive more than €750 million in consolidated revenues. *See* OECD/G20 Base Erosion and Profit Shifting Project, Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two): Pillar Two Rules in a Nutshell 1 (2021) [hereinafter Pillar Two Nutshell], <https://www.oecd.org/tax/beps/pillar-two-model-rules-in-a-nutshell.pdf>. [↑](#endnote-ref-192)
192. *See* Stephanie Soong Johnston, *U.S.-Style Minimum Taxation May Spread Without OECD Coordination*, 93 Tax Notes Int’l 1213 (Mar. 18, 2019); George Callas & Mark Prater, *Is GILTI Operating as Congress Intended?*, 166 Tax Notes Fed. 65, 67 (Jan. 6, 2020) (“In a related and now rapidly progressing development, the OECD is revisiting longstanding rules and norms of international taxation. Some of the discussions have focused on whether to propose a GILTI-inspired set of rules on a country-by-country or entity-by-entity basis.”). [↑](#endnote-ref-193)
193. A QDMTT is defined as a domestically enacted minimum tax that “(a) determines the Excess Profits of the Constituent Entities located in the jurisdiction (domestic Excess Profits) in a manner that is equivalent to the GloBE Rules; (b) operates to increase domestic tax liability with respect to domestic Excess Profits to the Minimum Rate for the jurisdiction and Constituent Entities for a Fiscal Year; and (c) is implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary, provided that such jurisdiction does not provide any benefits that are related to such rules.” GloBE Rules, *supra* note 194, at Art. 10.1.1. [↑](#endnote-ref-194)
194. *See* Pillar Two Nutshell, *supra* note 190*.* If the ultimate parent refuses to participate in the project, the right to levy the top-up tax passes to the jurisdiction hosting the entit(ies) on the next level down in the corporate hierarchy. *See id.* at 3. [↑](#endnote-ref-195)
195. OECD/G20 Base Erosion and Profit Shifting Project, Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two), at Art. 2.6.1 (2021) [hereinafter GloBE Rules], [www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf](http://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf). [↑](#endnote-ref-196)
196. *See* Nana Ama Sarfo, *Opting Out of Pillar 2*, 108 Tax Notes Int’l 136 (Oct. 10, 2022) (“Because the QDMTT gives source countries a first taxing right, it encourages them to introduce a QDMTT yet does not place them at a competitive disadvantage for doing so. This is because another country will tax the income if the source country chooses to forgo the opportunity.”). [↑](#endnote-ref-197)
197. *See* Pillar Two Nutshell, *supra* note 190*.* [↑](#endnote-ref-198)
198. *See* Belisa Ferreira Liotti et al., *The Treatment of Tax Incentives Under Pillar Two*, 29 Transnational Corps. 25, 27 (2022), <https://unctad.org/system/files/official-document/diaeia2022d3a2_en.pdf> (“This means that jurisdictions are still ‘free’ to adopt tax incentives and CIT rates below 15%, but these measures risk being affected by the application of the GloBE Rules….”). [↑](#endnote-ref-199)
199. *See id.* at 25-26 (chart of tax incentives likely to be impacted by Pillar Two). [↑](#endnote-ref-200)
200. A jurisdiction may be able to tax some types of income at less than 15 percent and others at more than 15 percent, as long as each taxpayer pays tax at an average 15 percent rate. [↑](#endnote-ref-201)
201. GloBE Rules, *supra* note 194, Art. 4.32(c) (“[I]n the case of a Constituent Entity whose Constituent Entity-owners are subject to a Controlled Foreign Company Tax Regime, the amount of any Covered Taxes included in the financial accounts of its direct or indirect Constituent Entity-owners under a Controlled Foreign Company Tax Regime on their share of the Controlled Foreign Company’s income are allocated to the Constituent Entity….”). “Controlled Foreign Company Tax Regime” is defined as “a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign entity (the controlled foreign company or CFC) is subject to current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder.” *Id.* at Art. 10.1.1. [↑](#endnote-ref-202)
202. *Id.* at Art. 5.2.3. [↑](#endnote-ref-203)
203. *See* OECD, *supra* note 156.. [↑](#endnote-ref-204)
204. *See* OECD/G20 Base Erosion and Profit Shifting Project, Tax Challenges Arising from the Digitalization of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two) (2021), <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf>. [↑](#endnote-ref-205)
205. The OECD is now projecting a start date in 2024, at least for some countries. *See* Grant Wardell-Johnson, *OECD’s Pillar One and Pillar Two—A Question of Timing*, Bloomberg Tax Rept. (June 14, 2022), <https://news.bloombergtax.com/daily-tax-report-international/oecds-pillar-one-and-pillar-two-a-question-of-timing> (“at Davos, the Secretary-General of the OECD…indicated that the implementation of Pillar One would be delayed until 2024” and Pillar Two will start even later). [↑](#endnote-ref-206)
206. *See* *EU Finance Ministers Are Unable to Adopt Pillar Two Directive as Hungary Changes Position*, EY: Tax News Update (June 20, 2022), <https://taxnews.ey.com/news/2022-0957-eu-finance-ministers-are-unable-to-adopt-pillar-two-directive-as-hungary-changes-position>. [↑](#endnote-ref-207)
207. It did include a corporate minimum tax on book income, which is discussed in the next section of this Article. Few consider the new minimum tax to be compliant with Pillar Two, either as a QDMTT or an IIR, but it likely is considered a CFC regime for Pillar Two purposes. *See* Raymond Wynman & Andrew Wai, *The Inflation Reduction Act of 2022 and the Status of Pillar Two in the US*, Global Tax Mgmt. (Sept. 30, 2022), <https://gtmtax.com/tax-insights/articles/the-inflation-reduction-act-of-2022-and-the-status-of-pillar-two-in-the-us/> (“There are significant differences between the Act and Pillar Two in the US.”); Josh Odintz et al., *Knight Watch—Part I: The Book Minimum Tax*, 100 Taxes 10 (Oct. 2022) (“Because the [book minimum tax] taxes foreign profits, it fails the first two prongs of the definition of a QDMTT. But it is certainly a DMTT!...The [book minimum tax] is clearly not an IIR, as it allows an applicable taxpayer to blend jurisdictions and cross-credit FTCs, but it does operate like a CFC tax regime by topping up the income earned by the CFC at the shareholder level.”). *But see* Reuven S. Avi-Yonah & Bret Wells, *Pillar 2 and the Corporate AMT*, 107 Tax Notes Int’l 693, 696 (Aug. 8, 2022) (“Treasury should argue that the portion of any CAMT related to low-taxed U.S. domestic income is itself a QDMTT entitled to first-priority status…. Because the CAMT will be based on applicable financial statements, it will be possible to determine the portion of the CAMT related to the U.S. segment reporting unit.”). [↑](#endnote-ref-208)
208. *See* Assaf Harpaz, *International Tax Reform: Challenges to Multilateral Cooperation*, 44 U. Pa. J. Int’l L. (forthcoming 2023) (“[S]uch ambitious cooperation might be more than countries can accomplish.”). [↑](#endnote-ref-209)
209. Pub. L. No. 117-169 (2022). [↑](#endnote-ref-210)
210. *See* U.S. Dep’t of Treasury, The Made in America Tax Plan 2(2021), <https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf>. [↑](#endnote-ref-211)
211. Code Sec. 55(a), (b). [↑](#endnote-ref-212)
212. Tested years begin with years ending after December 31, 2021, but a December 31, 2022 tested year could take into account 2020 and 2021. [↑](#endnote-ref-213)
213. Code Sec. 59(k)(2). [↑](#endnote-ref-214)
214. As defined in Code Sec. 451(b)(3) “or as specified by the Secretary in regulations or other guidance.” Code Sec. 56A. [↑](#endnote-ref-215)
215. The taxpayer must make related-party adjustments to include amounts properly allocated to consolidated group members, dividends and other amounts includible in gross income (other than subpart F and GILTI inclusions) or deductible as a loss from non-consolidated group member corporations. If the taxpayer is a partner in a partnership, the taxpayer must include distributive shares of AFSI of the partnership, as well as AFSI of any disregarded that are not included on the taxpayer’s applicable financial statement. Code Sec. 56A(c)(2). [↑](#endnote-ref-216)
216. Code Sec. 56A(c)(3). [↑](#endnote-ref-217)
217. AFSI is decreased by bonus and accelerated tax depreciation with respect to tangible property (rather than book depreciation). Financial statement reporting rules for amortizing/depreciating intangibles and any other property that falls outside of the section 167 rules for section 168 property otherwise govern. AFSI is decreased by the lesser of (1) the aggregate amount of financial statement NOL carryovers to the tax year or (2) 80% of AFSI computed without regard to financial statement NOLs. A financial statement NOL for any tax year may be carried over to each tax year following the tax year of loss. “Financial statement NOL” is defined as the amount of net loss on the corporation’s AFS, after applying the AFSI adjustments, for tax years ending after December 31, 2019. AFSI is adjusted upwards by amounts attributable to elections for direct payment of certain credits (e.g., Advanced Manufacturing Investment Credit). [↑](#endnote-ref-218)
218. Code Sec. 59(l)(1). [↑](#endnote-ref-219)
219. The definition of “regular tax” under Code. Sec. 55(c) is notably generous for this purpose, as general business and certain other credits are not subtracted from regular tax liability. General business credits may offset up to 75 percent of the tax (both regular tax and CAMT liability) otherwise imposed for a taxable year. Code Sec. 38(c). Thus, a regular tax liability of $15 before general business credits measured against a tentative minimum tax of $15 would result in no incremental CAMT, even though the taxpayer may reduce its tax liability to $3.75. [↑](#endnote-ref-220)
220. Mason, *supra* note 4, at 401. [↑](#endnote-ref-221)
221. The United States is also a “source” country, and undoubtedly will have to change some of its rules for the taxation of foreign and foreign-owned corporations earning income in the United States, particularly in light of the Inclusive Framework. But that is a subject for another paper. [↑](#endnote-ref-222)
222. There seems to be much less disagreement over the rule for passive income—it should be taxed at normal U.S. rates. However, it is not always easy to distinguish between passive and non-passive income. [↑](#endnote-ref-223)
223. It is worth noting that the original version of subpart F excluded investments in such countries from its coverage. *See* David J. Walmsley, *The Less Developed Country Exclusion From Subpart F*, 22 Nat’l Tax J. 425, 426 (1969) (describing former Code Secs. 954(b)(1) and 955). [↑](#endnote-ref-224)
224. *See* Daniel Shaviro, *supra* note 19, at 72. [↑](#endnote-ref-225)
225. These incentives include FDII, whose express purpose was to balance the effective U.S. tax rate imposed on sales of goods and services to foreign markets, regardless of whether a U.S. taxpayer undertakes those transactions directly or through a CFC. *See* U.S. Senate Budget Committee, *supra* note 189, at 370 (“The Committee believes that offering similar, preferential rates for intangible income derived from serving foreign markets, whether through 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.”). [↑](#endnote-ref-226)
226. *See* H.R. 13, 103d Cong., 1st Sess. (1993), §§ 401-404 (bill proposing repeal and replacement of foreign personal holding company and foreign investment company and passive foreign investment company rules; §1175 (excluding active financing income from subpart F income). [↑](#endnote-ref-227)
227. *See* Taxpayer Relief Act of 1997, Act §§1121 & 1124 (adding a new Code Sec. 1296(e) excluding shareholders of CFCs from PFIC); American Jobs Creation Act of 2004, Pub. L. 108-357, Act §413(a)(1) (repealing foreign personal holding company regime formerly found in Code Sec. 552(a)(1), effective after December 31, 2004), §413(a)(2) (repealing taxation of gain on stock of Foreign Investment Companies). [↑](#endnote-ref-228)
228. *See*, *e.g.*, Peroni et al., *supra* note 170, at 482 (“The absence of a clear and principled anti-deferral policy, other than to strike an ad hoc balance between current income inclusion to achieve capital export tax neutrality and deferral to preserve competitiveness and capital import neutrality, is the source of much of the difficulty in applying Subpart F in new contexts and in formulating an appropriate legislative regime.”). [↑](#endnote-ref-229)
229. And this seems likely, as some countries already have draft legislation in progress. For example, the United Kingdom has released draft Pillar Two legislation. *See* *Introduction of the new multinational top-up tax*, GOV.UK (July 20, 2022), https://www.gov.uk/government/publications/introduction-of-the-new-multinational-top-up-tax. [↑](#endnote-ref-230)
230. *See* Mindy Herzfeld, *Using Financial Statements: Comparing the Pillars and the Corporate AMT*, 108 Tax Notes Int’l 131 (Oct. 10, 2022) (“The tax bases proposed by the OECD and enacted by the U.S. Congress seek to circumvent challenges posed by legislative tax rules by using separate—and externally verified—sets of books as their starting points. To arrive at the final tax base, each regime requires adjustments to the financial statements that provide the initial foundation. Because their goals aren’t entirely consistent, the systems’ required adjustments also differ, as do their terminology and organizing principles. Having to keep track of three types of financial statement adjustments multiplies the complexities associated with the new regimes.”). [↑](#endnote-ref-231)
231. Assuming that the taxpayer’s regular tax base for U.S. tax purposes matches its book income, if, for example, 75 percent of a taxpayer’s income was U.S. source income subject to tax at a 21 percent rate, it would have no minimum tax liability if it paid no foreign taxes whatsoever on its remaining 25 percent of foreign source income. [↑](#endnote-ref-232)
232. *See supra* note 206 (on the CAMT’s departures from Pillar Two requirements). [↑](#endnote-ref-233)
233. *See* Lee A. Sheppard, *Book Income Minimum Tax as Prepayment*, 176 Tax Notes Fed. 1959 (Sept. 26, 2022) (“When book effects are taken into account, the new book income minimum tax is a prepayment of regular tax.”). [↑](#endnote-ref-234)
234. Some argue that the CAMT already meets the requirements for a QDMTT. *See* Avi-Yonah & Wells, *supra* note 206, at 696 (“Given that the segment reporting on the financial statements will make it clear what portion of the CAMT relates to U.S. operations, the variances between the CAMT and the GLOBE rules should be viewed as minor such that the CAMT should be viewed as substantially equivalent to the GLOBE rules, at least in their practical operation vis-à-vis the U.S. jurisdiction.”). [↑](#endnote-ref-235)
235. It seems logical that the line, for both GILTI and FDII purposes, would end up at a 15 percent effective tax rate, as this is where IIRs, UTPRs, QDMTTs and the CAMT are converging. But the Code Sec. 250 deduction could be a relatively non-disruptive lever to pull depending on the degree of revenue generation or tax competition Congress finds acceptable. [↑](#endnote-ref-236)
236. H.R. Rep. No. 115-466, at 626-27 (Dec. 15, 2017) (conference report) (emphasis added). [↑](#endnote-ref-237)
237. Specifically, there are meaningful distortions and residual U.S. tax on GILTI resulting from the allocation and apportionment of deductions to GILTI and the interaction between GILTI’s lack of foreign tax credit carryforwards and the timing mismatches of overall foreign losses, separate limitation losses and overall domestic losses. Of course, the overall foreign loss (“OFL”), separate limitation loss (“SLL”) and overall domestic loss (“ODL”) rules are meant to work over a multi-year time horizon and thus everything “evens out” when there are losses in some years, but income in other years. Taxpayers that find themselves in a loss position that persists longer than the 10-year statute of limitations generally available for foreign tax credits in other baskets might argue that the section 904 framework is harsh in general. But there is no question that the situation is uniquely punishing in the GILTI context. *See* Tax Executives Institute Inc., Comments on REG-105600-18, Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the TCJA (Feb. 5, 2019) (“SLLs generally do not create adverse foreign tax credit implications to the extent that they are recaptured within the 10-year foreign tax credit carryover period—that is, in general, the carryover period for such SLLs sufficiently ameliorates the temporary suspension in the first year, GILTI SLLs are an exception, however, because foreign taxes properly attributed to the section 951A category cannot be carried over to a future taxable year. There is no indication that this disparate treatment of GILTI SLLs was intended by the [TCJA]. Accordingly, TEI recommends that either (i) SLLs should not be permitted to arise with respect to the section 951A category or (ii) foreign taxes properly attributable to section 951A category income should ‘hover’ until the SLL with respect to the section 951A category is recaptured. Absent relief, an affected taxpayer would permanently lose the benefit of the foreign tax credit to the extent that a SLL is created with respect to the section 951A category.”). [↑](#endnote-ref-238)
238. *See*, *e.g.*, Stewart R. Lipeles et al., *Foreign Tax Credit Planning: The Potential Benefits of Subpart F Income*, 96 Taxes 7 (Sept. 2018). [↑](#endnote-ref-239)
239. In prior comment letters, taxpayers had requested that Treasury at least address the problems caused by allocation and apportionment of deductions to the GILTI basket through regulations, given that the TCJA legislative history to the GILTI regime explicitly stated in a footnote that U.S. taxpayers would not pay residual U.S. tax on a GILTI inclusion when the foreign jurisdiction taxed such income at a rate equal to 13.125%. *See, e.g.*, Illinois Tool Works Inc., Request for Guidance on Expense Apportionment to Global Intangible Low-Taxed Income (Apr. 4, 2018) (“There is no policy reason for requiring apportionment of U.S. shareholder expense in the GILTI context.”); Mastercard Incorporated, Recommendations Relating to the Global Intangible Low-Tax Income (“GILTI”) Regime (July 26, 2018) (“In accordance with legislative intent…there should be no residual U.S. federal income tax on a GILTI inclusion to the extent the underlying income was taxed, on an aggregate basis, at a rate of at least 13.125%.”); Retail Industry Leaders Association, Request for Guidance on Expense Apportionment to Global Intangible Low-Tax Income (June 25, 2018) (“The unintended negative consequences of the expense apportionment regulations that were drafted well before GILTI was enacted are inconsistent with the intent of the new law, result in unfair outcomes for many taxpayers and place U.S. companies at a competitive disadvantage vis-à-vis their foreign owned competitors.”). [↑](#endnote-ref-240)
240. Guidance Related to the Foreign Tax Credit, Including Guidance Implementing Changes Made by the Tax Cuts and Jobs Act, Notice of Proposed Rulemaking, 83 Fed. Reg. 63200 (proposed Dec. 7, 2018) (finalized by T.D. 9822, Dec. 16, 2019) (“Congress added a new separate category under section 904(d)(1) for amounts includible under section 951A and amended section 904(c) to disallow carryovers of excess foreign tax credits in that category, but did not modify the existing rules under section 904 or sections 861 through 865 to provide for special treatment of expenses allocable to the section 951A category.”). [↑](#endnote-ref-241)
241. H.R. 5376, § 138124(a) (Nov. 19, 2021) (committee print). More precisely, section 904 would be applied on the basis of “taxable units,” *id.*, a term that traces its lineage to Treasury’s designation of regarded, disregarded, branch and non-branch taxpaying entities for foreign tax purposes in the foreign income tax allocation and apportionment regulations, the Code. Sec. 904 regulations and the GILTI high tax exception regulations. See Reg. §§ 1.861-20(d)(3)(v)(E)(9); 1.904-6(b)(2)(i)(B); 1.951A-2(c)(7)(iv)(A). [↑](#endnote-ref-242)
242. H.R. 5376, § 138124(e). In contrast, the FY2023 Green Book proposal would have continued to allocate and apportion deductible expenditures to the GILTI basket, and would have applied Code Sec. 265 to disallow deductions allocable to tax-exempt income, including the portion of a GILTI inclusion eligible for the Code Sec. 250 deduction and foreign-source dividends eligible for the section 245A dividends received deduction. *See* Stephen E. Shay, *Addressing an Opaque Foreign Income Subsidy With Expense Disallowance*, 103 Tax Notes Int’l 573 (Aug. 2, 2021) (critiquing the regulatory innovation that exempts the portion of GILTI stock attributable to the Code Sec. 250 deduction and “pushes” the interest deductions onto other asset categories; rather, the “correct” result under Code. Sec. 265 would be for the exempt portion of the GILTI asset to “attract and dump” a proportionate amount of the interest deduction, resulting in apportioning a smaller amount of interest deduction, in total, across all assets and greater U.S. tax liability). [↑](#endnote-ref-243)
243. H.R. 5376, § 138124(a)(2) (amending Code Sec. 904(f)(5)(B) to first allocate SLLs to separate limitation income in non-GILTI baskets and to treat each separate country within a section 904(d) category as its own separate limitation category for purposes of SLL and OFL recapture). [↑](#endnote-ref-244)
244. That is, Code Sec. 904(g) would continue to require ODLs to offset foreign source income within each section 904(d) category, including GILTI, resulting in loss of limitation. [↑](#endnote-ref-245)
245. Some of these activities were problematic because of a history of tax avoidance behavior. In other situations, though, income was brought within the purview of subpart F to enforce non-tax related prohibitions. *See, e.g.*, Code Secs. 952(a)(3) (international boycott income); 952(a)(4) (illegal bribes and kickbacks); 954(a)(5) (income earned in a country sponsoring terrorism). [↑](#endnote-ref-246)
246. *See* J. Clifton Fleming Jr. et al., *Incorporating a Minimum Tax in a Territorial System*, 157 Tax Notes 73, 80 (Oct. 2, 2017) (“Consistent with practice in other developed countries, current taxation of passive income (under subpart F) should be retained so that the exemption does not encourage tax avoidance on mobile passive income.”). [↑](#endnote-ref-247)
247. See *supra* note 244 regarding penalizing boycott participation, engaging in bribery and doing business in rogue states. [↑](#endnote-ref-248)
248. H.R. 5376, § 138129(a) (Sept. 27, 2021). [↑](#endnote-ref-249)
249. H.R. 5376, § 138129(a) (Nov. 19, 2021). [↑](#endnote-ref-250)
250. *See* David G. Noren, *What Role for Subpart F in a GILTI 2.0 World?*, 50 Tax Mgmt. Intl J. No. 11 (Nov. 3, 2021) (“In this environment, the United States will have gone a good part of the distance toward the simple ‘repeal deferral’ option long favored by capital export neutrality advocates pre-TCJA, and will have done so at some risk to U.S.-based multinationals’ competitiveness to the extent that the U.S. GILTI changes go further or are adopted earlier than other countries' Pillar Two income inclusion regimes. In light of these considerations, there is much less need for a separate, tougher regime like subpart F with respect to such income.”) (addressing the Ways and Means Committee BBBA legislative text). [↑](#endnote-ref-251)
251. See *supra* note 173 and accompanying text. [↑](#endnote-ref-252)
252. Gary Clyde Hufbauer, U.S. Taxation of International Income: Blueprint for Reform 131 (1992) (“An unfavorable tax climate can prompt US multinationals to shift part of their production and headquarters activities (including R&D) to sites abroad.”). *See also* *The Future of the New International Tax Regime*, 24 Ford. J. of Corp. & Fin. Law 219, 294 (Comments of Danielle Rolfes) (“If a country tries to solve base erosion by just taxing subsidiaries of companies with parents located in that jurisdiction, you end up with an inversion problem, or the problem of foreign companies potentially being more attractive bidders for your companies so that the United States would never win the jurisdictional choice for the parent company following a business combination.”); Daniel Shaviro, *The David R. Tillinghast Lecture, The Rising Tax-Electivity of U.S. Corporate Residence*, 64 Tax L. Rev. 377, 378 (2011) ( “Increasingly, Americans forming new companies with global business potential, as well as foreigners who want to reach investors in U.S. capital markets, have found that they do not need to pay the tax price of incorporating at home…. I have heard U.S. tax lawyers joke that recommending (or even not objecting to) U.S. incorporation of an intended global business verges on being malpractice per se.”) [↑](#endnote-ref-253)
253. Reg. § 1.861-9T(a) (“Consistent with the principles of fungibility, except as otherwise provided, the aggregate of deductions for interest in all cases shall be considered related to all income producing activities and assets of the taxpayer and, thus, allocable to all the gross income which the assets of the taxpayer generate, have generated, or could reasonably have been expected to generate.”). [↑](#endnote-ref-254)
254. Code Sec. 864(e)(2); Reg. § 1.861-9T(g)(1)(i). [↑](#endnote-ref-255)
255. Treasury adopted this approach in proposing the post-TCJA regulations on allocation and apportionment of deductions to the GILTI basket. *See* Guidance Related to the Foreign Tax Credit, *supra* note 239 (“The comments nevertheless suggest that taxpayers’ inability to reduce U.S. tax on non-section 951A category income (such as U.S. source income) with the excess credits is tantamount to imposing U.S. ‘residual tax’ on section 951A category income, even though the actual U.S. tax liability on that income, as reduced by foreign tax credits, is zero. The comments suggest that in order to assure full utilization of foreign tax credits associated with section 951A category income that is subject to a foreign effective tax rate of 13.125 percent or greater, no expenses should be allocated and apportioned to the section 951A category income. The Treasury Department and the IRS have determined that the Act is not consistent with this view of how the section 904 limitation should apply to the section 951A category.”). [↑](#endnote-ref-256)
256. As some have said, “the TCJA is not for losers.” *See, e.g.*, Stewart Lipeles et al., *The TCJA Is Not for Losers*, 48 Tax Mgmt. Int’l J. 423 (2019) (“Loss taxpayers also suffer under the §904(f) and §904(g) separate loss limitation (SLL) rules…. These rules were enacted to prevent the double taxation of foreign-source income by recharacterizing income in a later year to permit the use of FTCs that relate to the prior income that was offset by a loss in another basket. This approach for SLL[s] does not achieve the intended result if the taxpayer cannot carry the relevant FTCs forward.”). [↑](#endnote-ref-257)
257. After Code Sec. 250 deduction. [↑](#endnote-ref-258)