Puzzling Illustrations of the Administration's GILTI Proposals

By Caroline H. Ngo

As noted in the prior column, the Biden Administration's proposals with respect to GILTI are harsh and significantly harsher than the OECD's proposed minimum tax being negotiated with the United States and the international tax community.[1] This column illustrates the tax results of a few simple fact patterns under the Administration's proposed revisions to the GILTI[2] regime. In particular, this column focuses on the proposed increased tax rate on GILTI to 21 percent when combined with (1) the 20-percent "haircut" on taxes deemed paid with respect to GILTI and (2) expense apportionment.

As illustrated by simple examples, retention of the 20-percent haircut would have a considerable impact on effective tax rates (in addition to the proposed tax rate increase and the proposal to apply GILTI on a country-by-country basis). In addition, expense allocation and apportionment together with application of GILTI on a country-by-country basis will lead to situations where high-taxed foreign subsidiary income is subject to additional U.S. tax.

20-Percent Haircut

The Biden Administration has proposed increasing the tax rate on GILTI to 21 percent, while the United States and the international tax community are working towards a minimum tax of at least 15 percent. The Administration has not proposed repealing the 20-percent haircut with respect to GILTI taxes found in Code Sec. 960(d)(1). Code Sec. 960(d)(1) provides that, if any amount is includible in the gross income of a domestic corporation under Code Sec. 951A, such domestic corporation is deemed to have paid foreign income taxes equal to *80 percent* of the product of such domestic corporation's inclusion percentage (as defined in Code Sec. 960(d)(2)) multiplied by the aggregate foreign income taxes paid or accrued by CFCs. Thus, at most, only 80 percent of the foreign income taxes paid or accrued by CFCs with respect to GILTI would be deemed paid and thus eligible for a foreign tax credit (and the remaining 20 percent would be "haircut" and lost forever).

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Applying the 21-percent proposed tax rate to GILTI, together with the 20-percent haircut, a CFC would need to pay or accrue foreign income tax at a tax rate at least equal to *26.25 percent* in order to avoid incremental U.S. tax on the foreign income.[3] This is in stark contrast to the *15 percent* minimum tax that the international tax community is negotiating.

In fact, if a U.S.-parented CFC were organized and operating in a foreign country that was fully compliant with the proposed minimum tax of 15 percent, the U.S. parent would still pay an additional U.S. tax on the income by reason of both the increased tax rate and the haircut. For instance, if a CFC were organized in Country X, which imposed a 15-percent corporate income tax, a domestic corporation would pay *an additional nine percent* of U.S. tax on that income,[4] resulting in an effective tax rate of *24 percent* on the income (U.S. tax of nine percent and foreign income tax of 15 percent).

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Code Sec. 960(d) was added as part of the TCJA's new GILTI regime. Legislative history describes the new GILTI regime as addressing a concern that taxpayers would move intangible property to a no or low-tax jurisdiction and the income from the intangible property would not be subject to U.S. tax under a participation exemption system.[5] The legislative history explained that subjecting that income to current U.S. tax reduces the tax benefit of allocating that income to low- or zero-tax jurisdictions.[6] The legislative history also "recognizes that taxing that income at the full U.S. corporate tax rate may hurt the competitive position of U.S. corporations relative to their foreign counterparts, and has decided to tax that income at a reduced rate (with a portion of foreign tax credits available to offset U.S. tax)."[7] Legislative history describes the 20-percent haircut as addressing a concern that a full credit for foreign taxes with respect to GILTI would reduce the incentive for taxpayers to minimize the foreign tax they pay or encouraging foreign countries to adopt "soak-up" taxes.[8]

As taxpayers have realized, although GILTI was described as a backstop to a territorial system (*see* above), in practice, the GILTI rules tax the majority of foreign subsidiary income on a current basis (in contrast to the pre-TCJA system in which taxation of foreign subsidiary income was generally deferred until earnings were repatriated to the United States). The participation exemption added under the TCJA applies in very limited circumstances (*e.g.,* with respect to QBAI and tested income offset by tested losses). Under the current expanded regime, the foreign tax credit is key to reaching the intended U.S. taxation of most income of CFCs.[9] Reducing incentives to minimize foreign tax seems to be a significant concern in only narrow sets of situations. Thus, although the concern that gave rise to the 20-percent haircut may have been relatively narrow, the 20-percent haircut impacts the effective tax rate on most foreign subsidiary income.

Lawmakers are now in the process of negotiating tax increases. If lawmakers were to determine that the tax rate on foreign subsidiary rate should be different than the 21-percent proposed rate, lawmakers should disclose and submit for public debate the intended rate. The 20-percent haircut understates the "headline" tax rate of 21 percent on foreign subsidiary income.[10] The resulting hodge podge system makes it very difficult to discern what policy rationale underlies the adoption of new provisions or retention of components of the TCJA system, such as the 20-percent haircut. Lawmakers also should disclose the comparative benefits they anticipate from undercutting the competitive position of U.S. corporations relative to their foreign counterparts. As a general matter, lawmakers should describe the intended tax system—*e.g.*, territorial or worldwide—so that policy decisions could be made in alignment with such tax system. Without providing a framework for the intended system, the hodge podge system may just drift along without accomplishing any identified purpose.

Expense Apportionment

As a practical matter, an increase in the U.S. tax rate on net GILTI from 10.5 percent to 21 percent (or 18.75 percent[11]) would likely significantly mitigate the adverse impact of expense apportionment experienced by taxpayers post-TCJA. That said, application of expense apportionment and GILTI on a country-by-country basis would lead to situations where high-taxed foreign subsidiary income is still subject to U.S. tax.[12]

As background, the foreign tax credit limitation under Code Sec. 904 is determined, in part, based on a taxpayer's taxable income from sources without the United States, and the limitation is applied on a category-by-category basis. Regulations under Code Secs. 861 through 865 provide rules for allocating and apportioning deductions to determine, among other things, a taxpayer's taxable income from sources without the United States for purposes of applying Code Sec. 904. For example, with respect to GILTI, U.S. shareholder expenses allocated and apportioned to Code Sec. 951A category income reduce the taxpayer's taxable income in the Code Sec. 951A category for foreign tax credit purposes, and limit the ability for the U.S. shareholder to utilize foreign tax credits with respect to Code Sec. 951A category income. As illustrated in the below example, in general, a U.S. shareholder's foreign tax credit with respect to GILTI is limited to the lower of: (1) 80 percent of foreign income taxes paid and (2) U.S. tax on taxable income in the Code Sec. 951A category (*e.g.*, taking into account the Code Sec. 250 deduction and U.S. shareholder expenses apportioned to GILTI).

After starting in the direction of a territorial (participation exemption) system, but then abandoning that system, the expense allocation rules were retained for the GILTI regime and application of the foreign tax credit. Although the expense allocation and apportionment rules have been in place for many years, those rules had a *much* smaller impact on the pre-TCJA deferral regime as compared to the post-TCJA regime. One puzzling aspect of expense allocation is that it provides an incentive for shifting activities offshore because allocable expenses incurred by a U.S. shareholder reduces foreign tax credit utilization and thus increases the U.S. taxes paid on GILTI but the same expenses incurred by a CFC do not.[13]

Another puzzling aspect of expense allocation and apportionment is that it disproportionately impacts taxpayers with high foreign tax rates. To illustrate this point, assume that a U.S. shareholder has a CFC with 200 of GILTI (before taking into account the Code Sec. 250 deduction). In scenarios 1 and 2, CFC operates in a jurisdiction with a tax rate of 12 percent and 26.25 percent,[14] respectively. The amount of U.S. shareholder's interest expense that is allocated and apportioned to gross income in the Code Sec. 951A category for purposes of Code Sec. 904(a) is 40. The U.S. tax rate is assumed to be 28 percent and assumed to be 21 percent on GILTI. Below are the U.S. tax results (*see* Table 1).

As illustrated above, with respect to the CFC that operates in a higher-taxed jurisdiction, the apportionment of U.S. shareholder expenses reduces the Code Sec. 904(a) limitation in the Code Sec. 951A category and *thus reduces the ability for the taxpayer to utilize foreign tax credits*. Without expense apportionment, with respect to the higher-taxed CFC, the full 42 of FTC would be allowed such that the U.S. taxpayer would not incur U.S. tax with respect to that income. However, with expense apportionment, with respect to the higher-taxed CFC, only 30.80 of FTC would be allowed such that the U.S. taxpayer would incur 11.20 of tax with respect to that income.

In contrast, with respect to the CFC that operates in the lower-taxed jurisdiction, the taxpayer is *not impacted* by expense allocation and apportionment. The foreign tax credit with respect to the lower-taxed CFC is limited by the amount of foreign taxes paid (taking into account the 20-percent haircut), such that the U.S. tax with respect to the lower-taxed income is 22.80 with or without expense apportionment.

From a policy perspective, it is very odd, at the very least, to have rules that disproportionately impact taxpayers that have high foreign tax rates. High foreign tax rates are indicative of substance in developed economies. It seems

TABLE 1.

		No Expense Apportionment		With Expense Apportionment	
A	Foreign tax rate	12.00%	26.25%	12.00%	26.25%
B	GILTI	200	200	200	200
C	U.S. tax on GILTI pre-FTC (B × 21%)	42	42	42	42
D	Taxable income in GILTI category (taking into account a 25% Code Sec. 250 deduction and apportioned expenses of $40, if applicable)	150	150	110	110
E	FTC allowed (lower of the two)				
	1. 80% taxes deemed paid	19.2	42	19.2	42
	2. 904 limit (D × 28%)	42	42	30.8	**30.8**
F	U.S. tax post-FTC (C – E)	22.8	0	22.8	**11.2**

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odd to have rules that disproportionately impact taxpayers that have such substance (rather than taxpayers that transfer income to low-taxed jurisdictions, the intended target of the global *intangible low-taxed* income rules).

As a practical matter, with a higher U.S. tax rate on GILTI, expense apportionment would have a more limited impact as compared to post-TCJA. Taxes deemed paid limit—*see* E.1—would generally limit foreign tax credits and the FTC limitation (and expense apportionment)—*see* E.2—would limit foreign tax credits with respect to the narrow category of higher-taxed income. With respect to the taxes deemed paid limit, as noted above, if the tax rate on GILTI were to increase to 21 percent, the foreign tax rate would generally need to be at least 26.25 percent for the taxes deemed paid limit not to apply. Alternatively, if the tax rate on GILTI were to increase to 18.75 percent (rather than 21 percent), the foreign tax rate would generally need to be at least 23.4 percent (18.75 percent/80 percent) in order for the taxes deemed paid limitation in E.1 not to apply. Given that a limited number of foreign jurisdictions have a foreign tax rate that is at least 26.25 or 23.4 percent, the taxes deemed paid limit would in many situations apply. However, if a foreign tax rate is as high as 26.25 or 23.4 percent (as applicable), in applying GILTI on a country-by-country basis, taxpayers would be dismayed to find expense allocation and apportionment then kick in such that residual U.S. tax is owed.

Conclusion

As discussed above, some of the proposals will likely have considerable impacts on the effective tax rate on GILTI.

ENDNOTES

1. *See* Caroline H. Ngo, *Mind the Gap: Observations on the Differences Between the Minimum Tax Under GILTI and the OECD Framework*, INT'L TAX J., July-August 2021, at 3.
2. GILTI stands for "global intangible low-taxed income" and the GILTI rules are primarily set forth in Code Sec. 951A.
3. The tax rate of GILTI of 21 percent divided by 80 percent equals 26.25. This calculation just illustrates the haircut—it does not take into account other impacts, such as expense apportionment, which is discussed later in this column.
4. For instance, with respect to 100 of pre-tax tested income and 15 of taxes, the U.S. parent would only be deemed to pay 12 of taxes (80 percent of 15). Thus, the 21 of U.S. tax could be offset by 12 of taxes, resulting in additional nine of U.S. tax.
5. The legislative history states in part: "The Committee believes the type of income that is most readily allocated to low- or zero tax jurisdictions is income derived from intangible property, or intangible income. Intangible income is mobile and constitutes a large portion of the foreign-source income earned by U.S. corporations, and significant erosion of the U.S. tax base could result if no base protection measure were adopted in a move to a participation exemption system. At the same time, if intangible income is located in a jurisdiction with a sufficiently high tax rate, the Committee believes there is limited base erosion concern. Consequently, the Committee believes that taxing global intangible low-taxed income ('GILTI') on a current basis addresses the primary source of base erosion arising from a move toward a participation exemption system." Senate Budget Committee Explanation of the Senate Finance Committee bill (Dec. 7, 2017) ("Senate Explanation"), at 365. TNT Doc. 2017-99001.
6. *Id*.
7. *Id*.
8. The legislative history states in part: "The provision does not permit full foreign tax credits with respect to GILTI. The Committee believes that permitting a full foreign tax credit with respect to GILTI would make taxpayers indifferent between paying U.S. tax and foreign tax, and may reduce the incentive for taxpayers to minimize the foreign tax they pay or encourage foreign countries to adopt 'soak-up' taxes knowing that a taxpayer's combined U.S. and foreign tax liability may remain unchanged with the adoption of the soak-up tax if foreign tax credits were allowed in full. The Committee believes that allowing for partial foreign tax credits with respect to GILTI will result in an increase in the amount of U.S. tax revenue collected and decrease the amount of foreign tax revenue collected (relative to the case where full foreign tax credits are permitted with respect to GILTI)." *Id*., at 366.
9. The importance of the foreign tax credit with respect to GILTI is further magnified by the fact that foreign tax credits associated with GILTI are only available in the current year.
10. On August 25, 2021, Senate Finance Committee Chair Ron Wyden, D-Ore., and two other Senate Finance Committee Democrats Sherrod Brown of Ohio and Mark R. Warner of Virginia released a discussion draft ("Senate Finance Discussion Draft") providing more detail on their previously released international tax framework, which would amend the current rules on GILTI, subpart F, FDII, BEAT, and other rules. The Senate Finance Discussion Draft provides in part that the haircut is to be determined and would range between 0 and 20 percent. To align the subpart F and foreign branch rules, the Senate Finance Discussion Draft would also expand the haircut to apply to foreign taxes deemed paid with respect to subpart F and foreign branch income.
11. The GILTI rate of 21 percent is based on a 25-percent deduction, keyed off a proposed corporate tax rate of 28 percent. The more likely corporate tax rate may be around 25 percent, given the close margins in Congress and that key Democrats have publicly expressed support for increasing the rate to 25 percent. If the corporate tax rate lands at 25 percent, and assuming *arguendo* that the proposed Code Sec. 250 deduction stays at 25 percent, the tax rate on GILTI could potentially be 18.75 percent.
12. Calculating expense allocation and apportionment on a country-by-country basis can be expected to be very complex and time-consuming.
13. A release and section-by-section description that accompanied the Senate Finance Discussion Draft (the "Senate Finance Description") provides in part that the research and development expenses and stewardship costs would be allocated to U.S. source income (and not foreign-source income) "to prevent companies from paying higher taxes under GILTI when they invest in the United States." Thus, the Senate Finance proposal seems to recognize that expense allocation results in higher taxes when companies invest in the United States. The same logic should also apply to interest expense. Although "money is fungible," the sensibility of interest expense allocation to reduce foreign tax credit utilization is not readily obvious in an inclusion system.
14. To isolate the expense apportionment impact, the tax rate in the higher-taxed jurisdiction is set to 26.25 percent so that the 20-percent haircut is not applicable.

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