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Year-to-Year Tax Volatility Under a Country-by-Country GILTI Regime

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OVERVIEW

The current global intangible low-taxed income (GILTI) regime generally operates on an aggregate, global basis. That is, the tested income, tested losses, and foreign taxes of all controlled foreign corporations (CFCs) under a U.S. parent company are generally aggregated in determining the U.S. parent company's GILTI tax liability in a single, parent-level computation.[1] Thus, losses from a CFC in one country may offset income from a CFC in another country, and foreign taxes attributable to a CFC's operations in one country may be available as foreign tax credits to offset GILTI tax liability resulting from another CFC's operations in a different country. In light of various other aspects of the GILTI regime that can create harsh effects for taxpayers — such as the lack of any loss and foreign tax credit carryovers, expense allocation and apportionment against tested income, and the 20% ''haircut'' on foreign tax credits in the GILTI basket — the ability to average certain aspects of the GILTI computation across CFCs under this aggregate approach serves to soften some of the regime's hard edges.

The Biden administration, following through on candidate Biden's 2020 campaign proposals, wants to eliminate this aggregate approach and instead apply GILTI on a country-by-country (CbC) basis.[2] Senate Finance Committee Chairman Ron Wyden and other leading Democrats on the committee also have indicated an openness to enacting a CbC GILTI approach (or alternatively enacting a mandatory high-tax exception for GILTI purposes, which would have a similar practical effect).[3] In addition, it is envisioned that the GILTI-inspired income inclusion rule (IIR) being developed under the OECD ''Pillar Two'' initiative be applied on a CbC basis.[4]

Converting the U.S. GILTI regime to a CbC-based approach would be an unwelcome development for taxpayers in view of the resulting additional tax burden and complexity. Congress should carefully consider whether to take this step, and if it does, it should do so with an eye to ensuring that the U.S. GILTI regime in its totality is not more punitive (as a matter of either substance or timing of implementation) than the IIRs that other countries are thinking about adopting. That being said, in light of the apparent momentum behind the proposal, taxpayers need to consider the full implications of a CbC approach being adopted, and may well-serve themselves by weighing in on the issues surrounding better and worse ways of implementing it.

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[1] §951A (generally determining GILTI and net tested income at the U.S. shareholder level); §960(d) (providing a GILTI deemed-paid foreign tax credit generally aggregating the foreign taxes of a U.S. shareholder's various CFCs); §904(d)(1)(A) (providing a single foreign tax credit basket for all of a U.S. shareholder's GILTI and deemed-paid foreign taxes). All ''§'' references are to the Internal Revenue Code of 1986, as amended, and all ''Reg. §'' references are to the Treasury regulations promulgated thereunder.

[2] U.S. Treasury Department, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 28, 2021) (the ''Greenbook'').

[3] Sens. Ron Wyden, Sherrod Brown, and Mark Warner, Overhauling International Taxation (Apr. 2021) (the ''SFC Outline'').

[4] OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy (July 1, 2021) (stating that the IIR will apply ''on a jurisdictional basis''); OECD, Tax Challenges Arising from Digitalisation — Report on Pillar Two Blueprint (Oct. 12, 2020) (earlier, more detailed discussion of same), available at (the ''OECD Pillar Two Blueprint'').

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Along these lines, one of the main concerns presented by a CbC GILTI approach would be the year-to-year tax volatility that would result from running GILTI computations on a CbC basis in the context of the GILTI regime's strictly annual application, without any loss or foreign tax credit carryovers. Taxpayers could find themselves falling in and out of GILTI tax liability from year to year with respect to CFC operations in the same country, simply due to factors such as pricing volatility in their key inputs or outputs, and timing mismatches stemming from different fiscal years and tax accounting conventions under U.S. and non-U.S. tax laws. If Congress decides to enact a CbC GILTI approach, it should be mindful of these volatility concerns and include carryover or other measures to smooth out GILTI determinations over time.

GILTI AS AN ODDITY OF TAX LAW DESIGN: A PURELY ANNUAL APPROACH WITH NO MITIGATION OF YEAR-TO-YEAR VOLATILITY

The problem is rooted in an unfortunate design choice Congress made when it enacted GILTI in 2017. Rather than providing mechanisms to smooth the operation of the GILTI regime over multi-year periods, Congress chose to make the regime a purely annual one. Thus, a $100 loss in Year 1 can mean no GILTI liability in Year 1, but then $100 of income in Year 2 can create GILTI liability in Year 2. Over the two-year period, income is zero but GILTI tax is still due. Similarly, if a taxpayer is in an excess credit position in the GILTI basket in Year 1, but then is in an excess limitation position in the GILTI basket in Year 2, the taxpayer pays GILTI tax in Year 1 unreduced by the excess credits, but then is unable to use those credits against its excess limitation in Year 2. Over the two-year period, the full amount of foreign tax credits should have been allowable within the limitation, but instead the credits simply vanish. Planning under the GILTI regime is thus a precarious business — taxpayers need to ''stick the landing'' each year or else lose the ability to use valuable tax attributes.

It didn't have to be this way. The issue of managing volatility and achieving sensible multi-year policy outcomes under an annual income tax is hardly new. A very selective list of examples elsewhere in the Code includes net operating loss carryovers under §172, foreign tax credit carryovers under §904(c) (for all foreign taxes except those in the GILTI basket), the subpart F qualified deficit rule under §952(c)(1)(B), the subpart F loss recapture rule under §952(c)(2) (a pro-fisc rule), and disallowed interest carryovers under §163(j)(2). The idea is that, while multi-year theoretical perfection may not be attainable under an income tax system that is administered for practical reasons on an annual basis, some adjustments to annuality are appropriate in order to avoid obviously inappropriate outcomes over at least limited multi-year periods.

Alas, whether for revenue reasons or they just ran out of time on the political calendar, Congress provided no such adjustments when it enacted GILTI as the clock ran down on 2017.[5]

HOW GILTI AGGREGATION SERVES TO ALLEVIATE VOLATILITY, AND HOW CbC GILTI WOULD EXACERBATE IT

So taxpayers are left having to ''stick the landing'' each year. This can be challenging, as market prices of a business's key inputs and outputs can cause a business to swing from loss to income positions and vice versa from year to year, with no ability to carry over tested losses from one year to another. In addition, differences in fiscal taxable years or other tax accounting conventions between U.S. and non-U.S. tax laws can cause foreign taxes to fall into different taxable years for U.S. and non-U.S. tax purposes, creating mismatches between when a foreign tax accrues and when the relevant income accrues for U.S. tax purposes. If tested income accrues for GILTI purposes in Year 1, but the foreign taxes do not accrue until Year 2 because the relevant foreign country requires a different fiscal year, then the foreign taxes associated with the Year 1 tested income may never be available as credits, as they had not yet accrued in Year 1, and the associated income necessary to provide limitation coverage is not available in Year 2 (and as noted above, the normal §904(c) carryover is turned off for the GILTI basket, so there is no hope of carrying the taxes to Year 3).

Against this backdrop, the global blending of income, losses, and foreign taxes under present law's aggregate approach provides some alleviation of year-to-year volatility. CFC1 may be in an unusual tested loss position in a given year, but this may be offset by an offsetting tested income position of CFC2 that operates in a different line of business and thus is not affected by the same market conditions as CFC1 is. Similarly, a timing mismatch between the accrual of CFC1's taxes and CFC1's tested income may be effectively smoothed out by a timing mismatch in the opposite direction with respect to CFC2's taxes and tested income. So you need to stick the landing, but this is a little easier under a global aggregate approach. If Congress eliminates cross-jurisdictional averaging, then failures to stick the landing will be more common, leading to multi-year tax outcomes that make little sense.

To be sure, there are other taxpayer benefits to this averaging, including the ability to use taxes in higher-

[5] Tax Cuts and Jobs Act, Pub. L. No. 115-97 (Dec. 22, 2017) (''TCJA'').

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tax jurisdictions to reduce the GILTI tax liability with respect to income earned in lower-tax jurisdictions. This effect does not represent anything nefarious, and indeed makes good policy sense from the standpoint of a tax regime tasked with imposing U.S. tax in a manner broadly geared to a U.S.-parented group's overall effective foreign tax rate: overall low foreign rate means more GILTI tax; overall high foreign rate, less GILTI tax. Justice does not necessarily require the prevention of this averaging.

That being said, in the event that Congress does implement a CbC GILTI approach in an effort to eliminate this averaging, it should understand that concomitant adjustments to the regime's purely annual approach will be necessary in order to avoid nonsensical multi-year outcomes like the ones described above.

POTENTIAL SOLUTIONS

The adjustments necessary in this regard may be relatively straightforward. Simply striking the final sentence of §904(c) would allow foreign taxes in the GILTI basket(s) to be carried back one year and forward 10 years, like all other foreign taxes can be under present law. This would go a long way toward mitigating the volatility resulting from income and tax timing mismatches arising from differences in U.S. and non-U.S. taxable periods and other tax accounting conventions. Tested loss carrybacks and carryforwards of some sort also should be provided in order to prevent the imposition of GILTI tax in situations involving no tested income on a multi-year basis. Some consideration would need to be given regarding whether to apply the carryovers at the U.S. shareholder level or at the CFC level.[6]

Some set of adjustments along these lines not only would make sense from a general tax design perspective, but also would be necessary to ensure an appropriate degree of alignment between the U.S. GILTI regime and the IIRs that may be adopted around the world under OECD Pillar Two.[7] If the Biden administration's international tax proposals are to be defended on the basis that other countries are enacting similar measures,[8] Congress should not fail to make obviously sensible adjustments to manage volatility as other countries are planning to do under their own tax regimes.

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[6] This discussion assumes that CbC would be implemented by making separate, country-specific GILTI calculations. If the approach of enacting a mandatory high-tax exception were instead to apply, as the SFC Outline suggested might be considered, further analysis may be necessary to effectuate these policies in the context of determining which locations are ''high-tax.''

[7] *See* OECD Blueprint (''The mechanism to address volatility is based on the principle that Pillar Two should not impose tax where the low [effective tax rate] is simply a result of timing differences in the recognition of income or the imposition of taxes. The [Pillar Two] rules therefore allow an MNE to carry-over losses incurred or excess taxes paid in prior periods into a subsequent period in order to smooth-out any potential volatility arising from such timing differences.'').

[8] *See, e.g.*, Responses of Treasury Secretary Janet Yellen to Questions for the Record From the Senate Finance Committee (Jan. 21, 2021) (stating that the goal of these proposals is to ''stop the race to the bottom on corporate taxation, and prevent global profit-shifting, while securing the competitiveness of U.S. companies''); Testimony of Treasury Deputy Assistant Secretary for Tax Analysis Kimberly A. Clausing before the Senate Finance Committee (Mar. 23, 2021) (suggesting that any competitiveness effects of the proposals should be manageable because ''to the extent that foreign countries also adopt strong minimum taxes, that will also reduce any competitiveness worries'').

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