The US International Tax Reforms: Competition and Convergence, Pay-Offs and Policy Failures

The Harvard community has made this article openly available. Please share how this access benefits you. Your story matters

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Citable link</td>
<td><a href="http://nrs.harvard.edu/urn-3:HUL.InstRepos:38236373">http://nrs.harvard.edu/urn-3:HUL.InstRepos:38236373</a></td>
</tr>
<tr>
<td>Terms of Use</td>
<td>This article was downloaded from Harvard University’s DASH repository, and is made available under the terms and conditions applicable to Other Posted Material, as set forth at <a href="http://nrs.harvard.edu/urn-3:HUL.InstRepos:dash.current.terms-of-use#LAA">http://nrs.harvard.edu/urn-3:HUL.InstRepos:dash.current.terms-of-use#LAA</a></td>
</tr>
</tbody>
</table>
The recent U.S. international tax reforms are a hodgepodge of nominal and effective tax rate reductions, a poorly designed export subsidy and unnecessarily complex revenue raising tax base protections. The most significant “international” change in the 2017 U.S. tax legislation is the “permanent” reduction in the U.S. corporate tax rate. The base protections were jerry built on existing architecture. There was no effort to address the pervasive issue of remote sellers into the U.S. market. The overall result is very complex, lacks policy coherence, and, over the longer term, loses revenue. While reduced rates moderate incentive effects the revised rules manage nonetheless to encourage offshore shifting of real investment as well as profits.

I. Introduction

The recent U.S. tax reform’s international provisions are difficult for policymakers in other countries to comprehend. They are complex and in certain instances inconsistent with U.S. international undertakings. Observers can best understand the underpinnings of U.S. international tax reforms in the frame of U.S. domestic politics.

With an eye to the mid-term elections, the primary objective of the overall U.S. tax reform was to benefit Republican (GOP) constituencies, including a tax cut for individuals, with benefits skewed to those with higher income, and a substantially reduced corporate tax rate. The legislation’s tax reductions were deficit financed.\(^1\) In service of the Trump GOP’s “make America great again” (MAGA) campaign theme, the focus of the reform’s international tax provisions was to champion U.S. multinational businesses to the extent of available budget space after providing domestic businesses their rate reductions. The international provisions are a hodgepodge of poorly designed tax benefits and base protections. The tax benefits included providing U.S. multinational corporations a low rate of current tax and relief from future U.S. tax on accumulated offshore earnings, a partial territorial system and a tax reduction for exports. Though most of the base protections are consistent with G20/OECD base erosion and profit

\(* \text{Senior Lecturer on Law, Harvard Law School. I thank Cliff Fleming for comments on an earlier draft. The views expressed in this paper are my own and do not reflect those of any university or organization that I am affiliated with or of any client for which I render pro bono or consulting services. I disclose certain activities not connected with my position at Harvard Law School, one or more of which may relate to the subject matter of this paper, at } \text{https://helios.law.harvard.edu/public/ConflictOfInterestReport.aspx?id=10794.}
\)

\(^1\) The tax legislation was estimated by the nonpartisan Congressional Budget Office to increase U.S. Federal deficits over 10 years by $1.5 trillion (not including macroeconomic effects) and with additional debt service by $1.8 trillion. Letter from CBO Director K. Hall to Senator R. Wyden (2 Jan. 2018).
shifting (BEPS) action items, their purpose was to pay for revenue lost by MAGA reforms more than to enforce international standards.

The tax reform changes failed to modernize an outdated tax infrastructure or to address the most important defect in the current cross-border tax architecture: market country taxation of remote sellers with no physical presence in the host economy. As the U.S. Supreme Court recently recognized in the context of State taxation, the world has changed and the physical presence rule is an anachronism that results in revenue loss and unfair treatment of domestic in relation to remote sellers.2

The article will proceed as follows. Part II reviews the political context and time pressure under which the tax legislation was adopted, which explains why it was not a fundamental tax reform. Part III.A reviews the most important “international” business provisions, starting with the pervasive effects of the reduction in the corporate tax rate and its interaction with credits for foreign income taxes. Part III.B examines the new global intangible low-taxed income (GILTI) and foreign dividends received deduction provisions, the reduced effective tax rate for foreign derived intangible income from exports and the base erosion alternative minimum tax or BEAT. Part IV comments on the most important international reform left unaddressed and Part V concludes.

II. The Drivers of U.S. Tax Reform

After months of high level talks and desperate to stave off 2018 mid-term election losses, the Trump Administration and Republican tax-writing committee leaders published on 27 September 2017, a skeletal “unified framework” for the tax-writing committees to write tax reform legislation.3 The final legislation was passed on 22 December 2017.4 The tax reforms adopted were heralded as a “tax cut” for the middle class and “small business” owners. The core of the business tax changes, however, were a massive uncompensated corporate tax cut, temporary expensing for domestic business investment (not for real estate), a low rate of current tax and relief from future U.S. tax on accumulated trillions of U.S. multinationals’ offshore earnings and a special tax reduction for income from exports. To limit a 10-year budget loss to $1.5 trillion and thereby avoid need for minority party support, the international provisions included revenue raising base protection provisions.5

---

3 Trump Administration, House Committee on Ways and Means (majority), and Senate Committee on Finance (majority), Unified Framework for Fixing our Broken Tax Code (27 Sept. 2017).
4 An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. 115-97 (22 Dec. 2017) (the tax law changes are known colloquially as the Tax Cuts and Jobs Act or “TCJA”).
5 The Unified Framework had specified only two international reform objectives. The first was to adopt a 100% dividend exemption for a 10% domestic corporate shareholder in a non-U.S. corporation and, as a “transition” to the new system, tax accumulated foreign earnings at a favorably low rate subject to a higher rate for earnings held in cash or equivalents. The second objective was to “prevent companies from shifting profits to tax havens … by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations,” while at the
That many of the international revenue raising provisions were consistent with the G20/OECD BEPS Project proposals was largely irrelevant for U.S. domestic political considerations. The substantial alignment of many provisions with international standards was convenient and may be used to support continued U.S. engagement in international organizations. The tax policies underlying these provisions, however, were secondary or tertiary considerations compared to their contribution to revenue from persons who would not or could not object politically.

The consistency of the tax reductions and MAGA theme with campaign promises brought President Trump’s support, but he apparently had little interest in the subtleties of tax policy. In the international arena, his obsession is with trade. As a result, it is too soon to tell whether the United States will continue to be an actor in the technical discussions that underlie international tax diplomacy and dialogue.


A. It’s The Tax Rate …

1. Tax Rate Convergence

The most significant “international” tax reform in the TCJA is the “permanent” reduction in the U.S. corporate tax rate from 35% to 21%. This rate reduction has pervasive effects and dwarfs in significance any other business tax provision. This section will briefly discusses the effect of the rate reduction on variations in industry effective tax rates, on income and wealth disparities (i.e., inequality), and on the relation of the U.S. corporate rate to those of other countries. It also considers the sustainability of the corporate tax rate reduction in light of Federal budget pressures.

What is important for cross border direct investment location decisions is the average effective tax rate (AETR). By that measure, U.S. companies were not over-taxed, domestically or abroad, prior to tax reform. The U.S. Treasury estimated the average effective “actual” tax rate on U.S. companies, excluding foreign subsidiaries, for 2007 to 2011 to be 22%. Because of the same time adopting “rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.” Unified Framework, supra n. 3, at 9.

6 An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, supra n. 4, §13001(a); I.R.C. §11(b).

7 M. P. Devereux and R. Griffith, Evaluating Tax Policy for Location Decisions, 10 Int’l Tax and Public Finance 2, 107 (2003) arguing that the AETR is the most appropriate measure for evaluating whether to make a new direct investment in one country or another country—a discrete choice between two mutually exclusive locations. The AETR measure may be contrasted with the effective marginal tax rate (EMTR), a metric used to make a decision whether to make a new investment or not by evaluating the impact of tax on the cost of capital. U.S. Dept. of the Treasury, Office of Tax Analysis, The Case for Responsible Business Tax Reform, 5-7 (Jan. 2017) (hereinafter “Treasury, Responsible Business Tax Reform”).

8 The Treasury’s measure of the average effective “actual” tax rate is corporate-level tax actually remitted (after credits for foreign taxes paid on foreign income earned directly and credits for foreign taxes deemed paid on actual foreign dividends) as shown on tax filings divided by book or financial statement income (rather than taxable income).Treasury, Responsible Business Tax Reform, supra n. 47, at 21; D. Fullerton, Which Effective Tax Rate?, 37 National Tax J. 1, 23, 30 (1984).
myriad of special deductions, credits and income definitions in the U.S. tax system, these AETRs varied materially by industry, from a low of 10% for utilities to a high of 28% for “all services.”

The TCJA eliminated some tax expenditures and added others (including temporary expensing of certain business assets), but made few structural changes to the tax base. Because of the disparate deductions and credits, it would be expected that the variations in AETR by industry will continue. The effect of a lower corporate tax rate, however, is to mitigate the significance of these differences (including the effects of temporary expensing). Deductions will be relatively less valuable (21% instead of 35% for the taxpayers that can utilize the tax benefit). Income will be more valuable after tax because of the reduced Federal tax take. The extent of convergence in effective tax rates among domestic industries will become clearer when data and new estimates become available in future years.

Rising income and wealth inequality is one of the most important social and economic issues in the United States and is a symptom of dysfunctional political and economic forces that threaten long term U.S. social stability and economic productivity. The benefits of the U.S. tax reform legislation generally were heavily skewed toward the rich, exacerbating rather than ameliorating this problem. The dominant short-term effect of the corporate rate reduction has been to increase the value of corporate stock. This windfall wealth effect largely benefits the wealthiest Americans, who, with their retirement plans, are the predominant holders of U.S. stock, and foreigners who own over 25% of U.S. equities. This wealth transfer is paid for with deficits that will require increased issuance of public debt the interest and principal on which will be paid with future taxes.

The United States’ looming demographic-based budget problem resulting from an aging population is estimated by the Congressional Budget Office (CBO) to require substantially increased public expenditures in coming years that contributes substantial pressure to increase revenues in future years. It is difficult to predict sources of future revenue increases.

The international trend for corporate tax rates has been downward, but the corporate rate in the United States has been sticky. It seems plausible, however, that in the United States corporate tax increases would precede adoption of a large scale consumption tax whether in the form of a carbon or other tax. This is one reason for businesses to be cautious in basing investment

---

9 Treasury, Responsible Business Tax Reform, supra n. 7, at Table 1.
11 Congressional Budget Office, The 2018 Long-Term Budget Outlook, 1 (June 2018);“In CBO’s projections, the federal budget deficit, relative to the size of the economy, grows substantially over the next several years, stabilizes for a few years, and then grows again over the rest of the 30-year period, leading to federal debt held by the public that would approach 100 percent of gross domestic product (GDP) by the end of the next decade and 152 percent by 2048. Moreover, if lawmakers changed current laws to maintain certain policies now in place—preventing a significant increase in individual income taxes in 2026, for example—the result would be even larger increases in debt.”
decisions on the sustainability of rate reductions. Less salient than headline rate changes and potentially more politically palatable ways to increase taxes on corporations would be to reduce deductions that provide special tax benefits, such as those discussed below to reduce the effective tax rate on “GILTI” or “FDII” income.

2. International Tax Rate Convergence

Prior to tax reform, U.S. multinationals did not pay high rates of foreign tax on their foreign subsidiary income and U.S. tax could be and was postponed on large amounts of offshore earnings. In 2014, the most recent year for which IRS CFC data is publicly available, the ratio of these CFCs’ foreign taxes paid (as reflected on IRS tax filings) to earnings and profits before taxes (under U.S. tax principles) was 10.07% in 2014.13

Foreign corporate tax rates have been declining over the last 20 years. According to OECD data, the reduction in the U.S. corporate income tax rate brings the combined U.S. federal and state tax rate much closer to combined foreign corporate income tax rates. Table 1 shows the changes in statutory tax rates between 2000 and 2018 for selected countries based on OECD data. The last column on the right is based on IRS tax data and shows the effective rate of foreign tax paid by controlled foreign corporations of U.S. multinationals that are organized in the country for that row.

Table 1

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>2000</td>
<td>2018</td>
<td></td>
</tr>
<tr>
<td>Selected Trading Partners</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>42.43%</td>
<td>26.80%</td>
<td>-15.63%</td>
</tr>
<tr>
<td>Germany</td>
<td>51.61%</td>
<td>29.83%</td>
<td>-21.78%</td>
</tr>
<tr>
<td>Japan</td>
<td>40.87%</td>
<td>29.74%</td>
<td>-11.13%</td>
</tr>
<tr>
<td>United States</td>
<td>39.34%</td>
<td>25.84%</td>
<td>-13.50%</td>
</tr>
<tr>
<td>Selected Low-Tax Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>24%</td>
<td>12.50%</td>
<td>-11.50%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>35%</td>
<td>25%</td>
<td>-10.00%</td>
</tr>
<tr>
<td>Switzerland**</td>
<td>24.93%</td>
<td>21.15%</td>
<td>-3.78%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>30%</td>
<td>19%</td>
<td>-11.00%</td>
</tr>
</tbody>
</table>

OECD Tax Database, Table II.1 Statutory corporate income tax rate (2018)

* Author calculations based on 2014 IRS Statistics of Income for profitable CFCs.

** Does not take account of companies eligible for special tax status, proposed to be repealed, or proposed tax reforms and rate reductions.

---

13 IRS, Statistics of Income Division, *U.S. Corporations and Their Controlled Foreign Corporations - Number, Assets, Receipts, Earnings, Taxes, Distributions, Subpart F Income, and Related Party Transactions, by Selected Country of Incorporation of Controlled Foreign Corporation, Tax Year 2014* (Sept. 2017), Table 2 and author's calculations. As part of tax reform, post-1986 deferred earnings of foreign subsidiaries are taxed at materially reduced tax rate of 8.5% (15% for earnings in cash or equivalents), with an elective ability to defer payment over 8 years. While treated as a revenue increase within the budget period because of the acceleration in tax, this provision was an important benefit sought- after by U.S. multinational corporations.
These rate relationships continue to be important under reformed U.S. international rules because of the broader scope of current U.S. taxation of foreign subsidiary income, even at lower effective U.S. rates, and more restrictive rules for crediting foreign income taxes.

3. Crediting Foreign Taxes after Tax Reform – Keep Foreign Taxes Low

Generally, under territorial systems, there are strong incentives to keep foreign taxes low. Each dollar of foreign tax saved will benefit the taxpayer since the taxpayer’s residence country will not impose additional tax. The partial dividend exemption system adopted in the U.S. tax reform also taxes currently substantial foreign income with limitations on credits for foreign taxes. Under the new hybrid territorial-worldwide regime there will continue to be pressure on companies (and foreign countries) to keep foreign taxes low. Subject to exceptions, foreign corporate-level taxes will be potentially allowable as credits up to the U.S. tax on foreign source net income determined by category of income.

Income earned through a CFC. For U.S. multinationals, foreign subsidiary (i.e., CFC) income generally will come in three parts each with its own set of foreign tax credit limitation categories and rules. Each category of income will have its own effective tax rate. A 10 percent U.S. corporate shareholder’s share of current income of a CFC will be one of the following kinds:

1. **Subpart F income.** The CFC’s “Subpart F income” currently included in the U.S. corporation’s income is taxed at a full 21% corporate tax rate (subject to separate foreign tax credit limitations for the CFC’s taxes on passive and general income).

2. **Global intangible low-taxed income (“GILTI”).** GILTI is determined at the shareholder level and is currently included in the U.S. corporation’s income. GILTI is measured as the shareholder’s share of all its CFCs’ “tested income” (which excludes Subpart F income) that exceeds a 10% return on profitable CFCs’ tangible assets. After a 50% deduction at the shareholder level, generally GILTI is taxed at a pre-foreign tax credit effective U.S. rate of 10.5% (subject to a foreign tax credit based on no more than 80% of foreign taxes attributable to the GILTI and a separate foreign tax credit limitation with no carryovers).

3. **Dividend income.** Remaining current year income that is not previously taxed as Subpart F income or GILTI, when distributed as a dividend, is eligible for a 100% foreign dividends received deduction (FDRD). This will result in an effective U.S. rate of zero. Attributable foreign taxes are not allowed as a credit because the income is exempt.

---

14 Income taxes of U.S. states should be taken into account in determining a global tax rate, but to keep the discussion manageable are not discussed in this article. In addition, this article does not discuss how the international tax rules apply to non-corporate U.S. taxpayers.

15 I.R.C. §§904(d), 951 and 960.

16 I.R.C. §§250, 904(d), 951A and 960(d).

17 I.R.C. §245A.

18 I.R.C. §245A(d). Disregarding state taxes, the global effective rate on this income is determined by applicable foreign taxes.
The global effective tax rate then depends on the combination of the foreign (host country) tax and the residual U.S. tax, if any, after a credit to the extent allowed for foreign taxes. Exempt dividend income is the most restrictive in relation to foreign taxes since foreign taxes are disallowed as credits altogether – but there is no residual U.S. corporate tax. GILTI is next most restrictive as foreign taxes on GILTI are limited to 80% of the attributable taxes and the remaining taxes are subject to a separate foreign tax credit limitation with no carryovers. The global effective rate of tax on GILTI depends on the 80% foreign tax credit after application of a limitation based on the pre-credit U.S. effective rate (with allocation of domestic expenses).\(^{19}\) Subpart F income is least restrictive as foreign taxes are fully creditable and allowed to carryover or back – but the income is currently subject to full U.S. corporate tax.

Directly-earned foreign income. Income earned by a U.S. corporation directly through a foreign branch is taxed currently at a full 21% rate and foreign taxes may be credited up to the 21% U.S. tax subject to a separate limitation with carryovers of excess taxes allowed.\(^{20}\) Foreign taxes on income earned directly by a U.S. corporation, and not through a foreign branch business, may be credited up to the U.S. tax on foreign source income. (The same is true for foreign taxes deemed paid on Subpart F income.) As discussed below, the US tax will be at a lower 13.125% effective rate if the income earned directly by the U.S. corporation is foreign derived intangible income (FDII).

In each of these cases passive and general category income are determined separately. High-taxed passive income is re-classified as general category income and excess foreign tax credits in the general category may be carried over, so the global effective rate on directly-earned income (including through a foreign branch) and Subpart F income generally is the higher of the applicable U.S. or foreign effective rates.

All of this makes for a system of substantial complexity and potential for unutilized foreign tax credits.\(^{21}\) Assessing the new landscape requires modelling with specific facts to determine actual global effective tax rates that are important for business and tax planning. The new potpourri of foreign tax credit limitations and related rules is summarized in the following table:

---

\(^{19}\) I.R.C. §§960(d). Foreign tax credits subject to the separate GILTI limitation cannot be used in a later or earlier year. I.R.C. §§904(c).

\(^{20}\) I.R.C. §904(c) and (d).

\(^{21}\) In addition, the base erosion alternative tax (BEAT) may effectively restrict use of foreign tax credits. I.R.C. §59A.
Table 2

Variations in Foreign Tax Credit Limits

<table>
<thead>
<tr>
<th>Category of foreign Income</th>
<th>Credit allowed</th>
<th>Separate Limit (SL) or Cross-credit (CC)</th>
<th>U.S. Expenses allocated</th>
<th>Max FTC Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>GILTI</td>
<td>80%</td>
<td>SL</td>
<td>Yes</td>
<td>10.50%</td>
</tr>
<tr>
<td>DRD - Exempt</td>
<td>0%</td>
<td>NA</td>
<td>NA</td>
<td>0%</td>
</tr>
<tr>
<td>Foreign branch</td>
<td>100%</td>
<td>SL</td>
<td>Yes</td>
<td>21%</td>
</tr>
<tr>
<td>General category foreign income</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General: foreign source income*</td>
<td>100%</td>
<td>CC</td>
<td>Yes</td>
<td>21%</td>
</tr>
<tr>
<td>FDII</td>
<td>100%</td>
<td>CC</td>
<td>Yes</td>
<td>13.125%</td>
</tr>
<tr>
<td>Passive (w/high tax kick-out)*</td>
<td>100%</td>
<td>SL</td>
<td>Yes</td>
<td>21%</td>
</tr>
</tbody>
</table>

* Includes Subpart F and directly earned income.

The pressure to keep taxes low to accommodate the lower general U.S. corporate rate and these limits on using foreign tax credits will be exacerbated to the extent that the United States continues to follow reasonably principled rules for allocating expenses incurred by the U.S. multinational to earn the foreign subsidiary’s income. It seems clear as a matter of statutory interpretation that these expenses must be allocated to foreign income, including GILTI, to determine the foreign tax credit limitation. Whether the expense allocation rules are weakened in regulations to be issued, which would further benefit foreign income, remains to be seen.

B. New U.S. International Tax Provisions for Taxing CFCs and Their Corporate Shareholders

1. Old Subpart F Income, New GILTI and FDRD

The U.S. controlled foreign corporation (or CFC) tax rules provide that Subpart F income and GILTI are taxed currently to a 10% or greater U.S. shareholder of the CFC. The principal categories of Subpart F income currently taxed are foreign base company income, which includes most passive income and certain sales and services income using a foreign base company. In practice, Subpart F base company sales or services income can be avoided or planned into fairly readily. A Subpart F income inclusion is fully taxed, at 21% to a domestic corporate shareholder, and is subject to a credit for foreign income taxes up to the U.S. tax on the income (but excess foreign tax credits may be carried back one year and forward 10 years).

---

22 A U.S. shareholder may elect to exclude from Subpart F foreign base company income, income taxed at an effective foreign tax rate of 90% or more of the top U.S. corporate rate. I.R.C. §954(b)(4), Treas. Reg. §1.954-1(d)(1). Ninety percent of the new corporate tax rate this would be 18.9%. (21% * 90% = 18.9%)
The TCJA adds current taxation of GILTI. GILTI is determined at the level of the U.S. shareholder (i.e., a U.S. person that owns 10% of the CFC). CFC “tested income” generally is a residual category of a CFC’s non-Subpart F income. GILTI is measured by aggregating the shareholder’s pro rata share of CFC tested income or loss of the shareholder’s CFCs and subtracting a 10% return on the shareholder’s share of the profitable CFCs’ tangible business investment.23 A 10% U.S. corporate shareholder is allowed a 50% deduction against GILTI so that the pre-foreign tax credit effective U.S. tax rate is reduced to 10.5%.24 GILTI may very generally be thought of as a residual category of non-Subpart F income to the extent it exceeds in amount 10% of adjusted basis in profitable CFCs’ tangible assets or is high-taxed.25

The U.S. tax liability on the income taxed as Subpart F or GILTI is after foreign tax credits under the rules described above. Once income is taxed under Subpart F or GILTI it is not taxed a second time when actually distributed.26

Finally, a 10% U.S. corporate shareholder is allowed a 100% dividends received deduction with respect to a dividend of CFC income that has not been previously taxed. Generally, this income will include the deemed 10% return on a CFC’s tangible business investment and any other income that avoids Subpart F and GILTI. This dividend income can include income subject to high foreign taxes, which taxes will not be allowed as foreign tax credits.27 Taxpayers and advisors are working to find ways to maximize exemption of lightly taxed foreign income with the 100% DRD.

Currently, taxpayers and advisors are modeling the effects of the new law on their facts. Key drivers of a global effective tax rate in relation to foreign business income earned through a CFC are:

1) A taxpayer’s CFCs adjusted tax basis in tangible business property. The amount of business property on a CFC’s balance sheet will vary by industry and business strategy, e.g., does the business outsource manufacturing (e.g., Cisco Systems and Dell) or engage in its own manufacturing (e.g. Harley Davidson and Intel);

2) The level of foreign taxes paid on profitable CFCs income and the applicable limitations on the taxes allowable as a foreign tax credit; and

---

23 CFC “tested income” does not include certain non-Subpart F income, including (i) income excluded from Subpart F income because it is taxed at an effective foreign tax rate of 90% or more of the top U.S. corporate rate, and (ii) income connected to a U.S. business. I.R.C. §951A(2)(a)(i). The tangible investment is measured by “adjusted basis,” or cost less depreciation under a specified straight-line method. I.R.C. §951A.


25 GILTI has no direct connection to income from intangibles other than it is in excess of a deemed 10% return to investment in tangible business assets used to earn business income outside the United States and measured using a straight line depreciation method over a specified life for the asset.

26 I.R.C. §959.

27 Unless limited by future regulations, it would be possible to cause very high-taxed foreign earnings to be Subpart F income, fully taxed at 21%, so that excess credits can be used against other income. Under current regulations it is possible to fail to elect exclusion of high-taxed income from Subpart F income on a CFC-by-CFC basis. Treas. Reg. §1.954-1(d)(1).
3) The expenses of the domestic corporation (e.g., for interest, R&D and corporate headquarter expenses) that must be allocated to the foreign income.28

The 20% haircut on creditability of foreign corporate taxes attributable to GILTI will result in the inability to credit some foreign taxes. As shown in the last column of Table 1, foreign effective tax rates in major trading partners are unlikely to be fully creditable, while foreign taxes in low tax countries such as Ireland, the Netherlands, Switzerland, and the United Kingdom, have a good chance of being creditable in relation to GILTI income (subject to the limit to 80% of GILTI taxes).

Unknowns affecting after-tax results on future investments include (i) the extent to which foreign taxes will increase with adoption by these countries of anti-tax avoidance rules to frustrate tax reduction planning, and (ii) U.S. multinationals’ and host countries’ responses. Judging from the generous treatment of on-shoring of assets in Ireland and the Netherlands and the direction of Swiss tax reforms, it seems likely that, while foreign taxes will increase from the very low levels reflected in the last column of Table 1, relatively low foreign effective tax rates will continue to be able to be achieved by U.S. multinational corporations.29

2. FDII

The TCJA adopted an export subsidy in the form of a special 37.5% deduction against so-called foreign-derived intangible income (FDII).30 As a counterpoint to GILTI, FDII is aimed at the portion of a domestic corporation’s domestic income that exceeds a 10% return on U.S. tangible business assets that is attributable to exports. The FDII deduction reduces to 13.125% the U.S. effective tax rate on income from goods sold to, services performed for and intellectual property licensed to foreign customers to.31 This effective rate equates to the GILTI rate (before allocation of domestic expenses) grossed up by 80% (the percentage of GILTI foreign taxes allowable as a credit (subject to the GILTI FTC limitation)).32 Exports are rarely subject to foreign taxes so (ignoring tangible investment) this rate makes FDII appear close to GILTI over a range of foreign tax rates up to 13.125% (assuming no allocable expenses) and superior at higher foreign

---

28 As observed previously, State income taxes also affect the global tax rate analysis. State taxation of CFC income and dividends varies from state to state. Many states are in the process of determining whether or not to follow Federal treatment of foreign income. See Alysse McLoughlin and Kathleen M. Quinn, Tax Reform: What the International Provisions Mean to the States, 87 State Tax Notes 557 (5 Feb. 2018).


30 Like GILTI, the misnamed FDII also has no direct connection to income from intangibles other than in amount it is in excess of a deemed 10% return to investment in tangible business assets used to earn business income (measuring assets based on cost less straight line depreciation method over a specified life for the asset). The portion of such excess income eligible for the benefit generally is the portion of such income that is from sales to foreign customers. FDII is most clearly described as an export subsidy; it does not bear a close resemblance to existing patent box regimes.

31 I.R.C. §250(b).

tax rates. For this reason it is claimed by some that FDII will attract business “back” to the United States. There are several reasons to question whether this will occur.

The first is that, taking FDII separately from new tangible business investment and assuming equivalent allocation of expenses, FDII does not provide a greater after-tax benefit than GILTI over foreign effective tax rates up to 13.125%. If we assume no tangible investment, no deductions allocable to GILTI and a modest foreign effective tax rate of 8% (which based on the last column of Table 1 is quite plausible), then a rough calculation would suggest that the tax cost of GILTI would be 12.1%. This would compare to the FDII tax of 13.125%. As Sanchirico points out, if the foreign tax rate is 13.125% or less, the global tax burden is never greater than 13.125%, whereas FDII is never less than 13.125% (again, disregarding tangible investment and allocation of domestic deductions to GILTI). Importantly, the GILTI rate can be achieved on sales to unrelated U.S. customers, whereas a domestic corporation that sells to U.S. customers must pay a full 21% tax rate.

Second, the export subsidy may not be sustainable in the face of budget pressures. Any broad export subsidy is likely to be an ineffective incentive over time in a world of free exchange rates as currencies would be expected to adjust and offset the benefit. In the face of budget pressures to raise revenues, described above, the underwhelming economic policy rationale for the FDII as an export subsidy should elevate it as a candidate for reduction or elimination.

A third and more salient reason to question the sustainability of the FDII deduction is that it likely is inconsistent with U.S. obligations under the WTO’s Subsidies and Countervailing Measures (SCM) Agreement, at least in respect of sales of goods. In addition to the potential

33 Assuming that FDII attracts no foreign tax and no allocation of deductions to GILTI, this rate relationship would cause FDII to be increasingly comparable to GILTI as effective foreign tax rates get closer to 13.125%.
34 10.5% + (20% * 8%) = 12.1%. This assumes that the U.S. and foreign tax bases are the same. This is a strong assumption, which includes the assumption that there are no allocable domestic expenses that would not also be allowed a deduction for foreign tax purposes.
35 Sanchirico, supra n. 32, at 19.
36 The base erosion minimum tax only applies to payments between related persons and does not apply to payments for intermediate goods (with an anti-abuse exception for post-effective date inversion transactions). I.R.C. §59A.
37 There is a strong tradition of business leaders and politicians not accepting economists’ arguments that currencies will adjust and offset the benefit of the incentive. See M. Feldstein & P. Krugman, International Trade Effects of Value-Added Taxation, in Taxation in the Global Economy 263 (A. Razin & J. Slemrod eds., 1990).
budgetary pressure to increase the FDII tax rate described above, the viability of the FDII is at risk of WTO retaliation.

Finally, the elimination of the active trade or business exception previously allowing tax free transfers of business assets to a foreign corporation and the tightening of Section 482 with respect to transfers of intangibles means that a transfers of tangible and intangible business assets into the United States cannot be reversed without potentially material tax costs.⁹ This will cause some investors to pause before structuring to hold assets in a domestic corporation to earn FDII.

3. The BEAT

The United States’ new “base erosion minimum tax” (known as the “BEAT”) is the U.S. entry in countries’ efforts to prevent source taxation base erosion.⁴⁰ This add-on tax is determined by applying a reduced rate of 10% to a tax base that is increased by adding back certain deductible payments to related foreign persons. If the BEAT tax liability exceeds a taxpayer’s regular tax liability after allowance of a partial quite limited menu of usual credits (and not including the foreign tax credit), the taxpayer must pay the difference as an additional “base erosion minimum tax.”

The BEAT only applies to large corporate taxpayers that have group aggregate average annual gross receipts over 3 years of at least $500 million and a “base erosion percentage” of base erosion tax benefits to base erosion payments for the taxable year of at least 3%.⁴¹ The BEAT affects large international taxpayers, whether U.S. - or foreign-owned, whose U.S. affiliate (or U.S. branch business) makes substantial payments to foreign affiliates (and/or that have substantial foreign tax credits). The tax is mechanical in its design and can apply in unexpected circumstances that might not be viewed as abusive.

As noted above, the BEAT applies to U.S. and foreign taxpayers. Particularly relevant to U.S. taxpayers, foreign tax credits are among the credits not decreasing regular tax liability for determining applicability of the BEAT. Accordingly, a BEAT liability is more likely if a taxpayer has foreign tax credits and is increased by using foreign tax credits to lower the hurdle for application of the BEAT minimum tax. The effective denial of some foreign tax credits is inconsistent with the spirit of U.S. tax treaties, which commit the United States to relieving double taxation through use of the credit mechanism. Many treaties, however, include introductory language in the credit article that preserves the right of the U.S. to limit the credit.⁴²

---

³⁹ IRC §§367(a) and 482 (last sentence).
⁴¹ I.R.C. §59A(e)(1). In the case of banks and registered securities dealers, the base erosion percentage is 2%, see § I.R.C. §59A(e)(1)(C).
⁴² The 2016 U.S. Model treaty language for example provides: “In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof),…”. U.S. Model Income Tax Convention, Art. 23(2) (17 Feb. 2016).
The U.S. would have a plausible argument that the BEAT is a form of limitation on the foreign tax credit (that only applies to large taxpayers). Even if the BEAT were not found to be a “limitation,” and the BEAT foreign tax credit provision was determined to be inconsistent with a treaty, the BEAT would nonetheless take precedence over an earlier adopted treaty.43

For purposes of achieving its anti-avoidance objective, the BEAT appears intended in part to hit foreign-owned groups, including to frustrate inversions of U.S. into foreign-owned groups. It extends to non-interest payments and also has a minimum tax element by reason of its limitation on tax credits. Like the U.K. diverted profits tax, it appears to be inconsistent with the intent of treaties.

The statute and conference report do not say whether the BEAT is intended to override an inconsistent treaty. Under U.S. law, the later-in-time to be adopted would prevail in the event of a conflict. While there may be dispute whether or not the BEAT is effective in avoiding the reach of treaties, it likely would be upheld in application by a U.S. court.

The BEAT is over- and under-inclusive. The BEAT reaches deductible payments even if the related payee is a conduit for a payment to an unrelated person.44 The BEAT does not apply to payments for goods included in cost of goods sold, so otherwise deductible royalties may be bundled in the purchase price for goods and thereby avoid the BEAT.45 The BEAT does not apply to a large range of small and medium size taxpayers that can and do engage in base erosion.46 The BEAT is not directed at digital activity and indeed misses most digital businesses altogether. The exact scope of the BEAT will await the promulgation of regulations, but it is a rough cut provision at best.

4. Where Does This Lead?

The reduced corporate tax rate brings the U.S. rate in line with or below trading partner countries’ statutory rates. Taken as a whole, the business reforms are unlikely to materially alter geographic patterns of real investment, though decisions in a particular case may depend in part on the length of a businesses’ production cycle and there is an incentive in a range of cases to locate real investment outside the United States. While profit shifting also will continue, the payoff for taxpayers is reduced by reason of the reduced statutory rate and the GILTI provision (assuming strategies are not successful to avoid GILTI and achieve exemption). Any welfare gains from reduction of profit shifting will have come at an extraordinary (and unnecessarily excessive) cost of windfall benefits to U.S. corporations and their existing shareholders with respect to the corporations’ pre-effective date offshore earnings.

43 See I.R.C. 7852(d); Lindsey v. Commissioner, 98 T.C. 672 (1992) (upholding 90% alternative minimum tax foreign tax credit even though inconsistent with U.S.-Swiss income tax treaty).
45 Note that capitalization regulations could defer deductions for royalties.
46 See Wells, supra n. 40, at 1030-31; Shaviro, supra n. 40, at 176-77.
IV. Real Reform Untouched by BEPS or US Tax Reform

The U.S. tax reforms are layered over the provisions of prior law without altering the basic structure.\textsuperscript{47} The corporate rate reduction is dramatic but not structural. The adoption of deductions for pass through businesses, foreign dividends, GILTI and FDII are important changes but all rely or draw on prior architecture. The tax reform changes failed to modernize an outdated income tax infrastructure.

On the international side, the reform failed to address the most important defect in the current cross-border tax architecture: host country taxation of remote sellers who do not have a physical presence in the host economy. Interestingly, the reasoning of the U.S. Supreme Court’s recent \textit{Wayfair} decision, which upholds State use tax collection obligations on remote sellers, articulates why host countries, including the United States, also must reconfigure their income tax regimes to systemically tax remote sellers – digital and non-digital. The Supreme Court majority said: “Each year, the physical presence rule becomes more removed from economic reality and results in significant revenue losses to States.”\textsuperscript{48}

Adapting U.S. international tax rules to deal with the today’s business reality has been left to future U.S. tax reforms. Taxing remote sellers and its attendant shift of taxing rights to market countries also was largely postponed in the OECD/G20 BEPS project. This issue already is the primary focus of international tax law development, albeit attention currently is misdirected toward exclusively digital economy taxation.

The United States has a large interest in the decisions on how the global tax rules will be recast to allow host countries to tax remote economic activity. It is in the long-term U.S. interest that updated international tax rules improve the existing system: (i) in treating neutrally host country businesses and remote businesses engaged in comparable activity, (ii) in attributing income to the host country that reflects the value contributed by the host economy with as little distortion as possible, (iii) in equivalent taxation of different legal forms of carrying on business locally or remotely, and (iv) in mitigating double taxation and preventing double non-taxation. Satisfying these objectives in managing this inevitable change will require full U.S. engagement in developing international standards. It is vitally important that the U.S. to remain engaged in ongoing multilateral dialogues for its views to be heard on this and other tax issues.

V. Conclusions

The U.S. tax reform’s most important change was the corporate rate reduction. Mandatory tax on old earnings eliminates most (but not all) of the overhang of untaxed offshore earnings, but

\textsuperscript{47} One can quarrel over the extent to which unlimited deferral constrained by Subpart F is structurally different from dividend exemption constrained by Subpart F and GILTI.

\textsuperscript{48} \textit{South Dakota v. Wayfair}, 585 U.S. ____ at 10 slip op. (21 June 2018).
that was less of an economic problem than it appeared to be.49 The limited economic benefits from uses so far of the repatriated cash should not be surprising.

The other international changes in the U.S. tax reform appear to still favor foreign over U.S. real investment if foreign taxes can be kept quite low. Responses of foreign countries to BEPS and the U.S. reforms likely will increase levels of taxes paid to foreign governments, but it does not appear likely the increases will be dramatic. Profit shifting likely will continue to pay off, even with current U.S. taxation of GILTI, but the pay-off will be smaller.

The complexity of the interactions of the moving parts in the international rules will require granular planning by taxpayers and modeling of results. This often results in finding unanticipated tax windfalls. Expect to see surprising outcomes. The jobs of international tax advisors remain safe.

It is time to turn to finding a new and stable equilibrium for the architecture of international tax rules that can command broad support. The central task in that regard is to agree on rules for market country taxation of remote sellers and remote participants in the host economy who do not have a physical presence – rules that are not limited to digital businesses.

---