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Practical Roadblocks to U.S. Adoption of a Global Minimum Tax

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One can scarcely pick up a newspaper these days without seeing a headline trumpeting the advent of a new global tax order based in part on a minimum tax. As has often been noted, the OECD's proposed minimum tax has a lot in common, at least conceptually, with the global intangible low-taxed income (GILTI) regime. But as has also often been noted, there are many difficult technical issues to be solved before GILTI could operate seamlessly within a global minimum tax framework not designed with U.S. tax rules in mind.

What has not often been noted is that the architecture of GILTI itself is inconsistent both with international norms and with the general architecture of the Code's ''outbound'' international provisions. Neither the Biden administration's proposals to amend the Code's international rules nor the Senate Finance Committee's ''International Framework'' addresses the fundamental problems created by GILTI's faulty architecture. In fact, these proposals exacerbate those problems by tinkering with the 2017 changes without understanding the foundational principles underlying the Code's international provisions. If there is any hope of conforming U.S. tax rules to a new global order, the GILTI regime, as well as some traditional rules, will need to be reexamined.

To see why this is so, one must begin by examining the premises and principles of Code subpart F,[1] enacted in 1962. It was felt at the time that fundamental jurisdictional limitations would not allow the United States to directly tax U.S. persons on the income of controlled foreign corporations (CFCs) using a partnership or consolidation approach. Instead, subpart F was based on the rationale that the United States could assert taxing jurisdiction over a significant U.S. owner of a CFC as if certain profits of the CFC were deemed distributed in a manner similar to the distribution of a dividend.

Several rules, each unique to U.S. taxation of international income and not used by other countries (even in their CFC rules), were required to make this ''deemed dividend'' fiction operative. First, a U.S. shareholder of a CFC could not be taxed on the CFC's subpart F income unless the CFC had ''earnings and profits'' (E&P).[2] This limitation followed directly from the deemed dividend construct; under Subchapter C, a dividend must be attributable to corporate E&P. Second, a rule was needed to avoid double taxation of the same E&P under subpart F and again when profits were actually distributed or ''repatriated.'' This was effected through an enormously complicated ''previously taxed income'' (PTI) regime pursuant to which subpart F inclusions do not reduce E&P until a distribution of PTI is made.[3]

At this point, one can see that subpart F's architecture is based on Subchapter C architecture and is quite

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[1] Section 951 to §965. All section references are to the Internal Revenue Code, as amended (the ''Code'').

[2] Complex rules were then needed to recapture the tax when E&P is generated in a later tax year.

[3] The tracing of PTI in this way was complicated for many reasons, including the fact that the rules needed to coordinate taxation under §951, §956, and §1248, and do not work well when ownership of a CFC's stock changes. For an illuminating summary of the complexity, see Doernberg, Koenenn, Lowry, and Tei-

complex. But this is only the beginning of the complexity. On top of all this was the need to avoid *international* double taxation of a CFC's earnings, which incidentally would never match its foreign taxable earnings because a CFC's earnings and income are calculated using U.S., not foreign, principles. There are in theory two ways in which to address international double taxation: through providing indirect foreign tax credits (FTCs) in respect of foreign taxes on the earnings taxed in another country, or through exempting from U.S. tax profits earned in another country. For reason that are obvious, while many countries use the exemption method for active income, the exemption method is almost never used anywhere in the world when the profits being taxed are passive investment earnings. Because subpart F was limited to taxing certain passive and/or mobile income and not all income of a CFC, Congress had no choice but to adopt the FTC method, rather than an exemption method, to avoid international double taxation of subpart F income.

Although the FTC rules have morphed several times over the years since 1962, the fundamental design of the FTC rules has not. In a nutshell, a U.S. shareholder of a CFC will be entitled to claim a credit against its U.S. tax on subpart F income only to the extent that the foreign tax on that income — all calculated using U.S. tax principles (with some especially one-sided presumptions[4]) — does not exceed the U.S. tax thereon. Because this calculation is done on a ''basket by basket'' basis in order to prevent unwarranted cross-crediting of high-taxed against low-taxed foreign income, the FTC rules are a paradigm of complexity. In many cases, the result will be ''stranded'' FTCs and international double taxation. (This of course explains why U.S. shareholders of CFCs spend so much time and effort structuring to avoid the worst of the FTC regime.)

Now introduce the GILTI regime enacted by the TCJA in 2017. Congress borrowed GILTI's operative rules from subpart F. This was a major error, for two reasons. First, whereas subpart F is based on Subchapter C principles tied to E&P, GILTI operates without regard to E&P; it simply taxes a portion of a CFC's active income to the U.S. shareholder without regard to any deemed dividend construct. Second, and even more significantly, GILTI applies to active income, indeed all income of a CFC other than subpart F income and a sliver known as ''QBAI.'' For these reasons, applying the FTC method of eliminating international double taxation of GILTI was not only unnecessary (as it had been for subpart F income), it was, as recent history has shown, simply wrong-headed. An exemption system should have been used for GILTI. The legislative history summarized below suggests that Congress simply did not appreciate the difference between the FTC method and the exemption method.[5]

Because GILTI applies to active income of a CFC, Congress should have understood that avoiding international double taxation of GILTI required the use of an exemption, rather than an FTC, approach. But Congress did not think this through, and in fact made the problem worse by creating a new FTC basket for GILTI. Moreover, FTCs in the GILTI basket can offset only 80% of GILTI, and any excess FTCs do not carry over from year to year. And to make matters even worse, Treasury and the IRS interpreted certain language in the legislative history to mean that if a CFC had a loss in any year, no FTC at all could be claimed, even if the ''loss'' CFC paid foreign taxes.

At least before the Biden administration and Senate Finance proposals came along, it is hard to imagine a more unprincipled and anti-taxpayer set of rules than the GILTI rules. It is clear that at least certain aspects of the rules were not understood by Congress. As most readers will recall, some tax commentators originally pointed to language in the legislative history of GILTI that suggested that if the effective rate of foreign tax on GILTI income were 13.125% or more,[6] there should be no residual U.S. tax on GILTI. Of course this was not to be, because by forcing GILTI's square peg into subpart F's round hole, Congress effectively incorporated all existing FTC rules into GILTI. These rules included rules that allocate deductions away from GILTI, arbitrarily reducing

gen, *Ordering Rules Make Your Head Spin? Here's Some Aspirin.* Available at SSRN: https://ssrn.com/abstract=277966.

[4] One notoriously anti-taxpayer provision, deliberately intended to be unfair, was the rule of §864(e) that operates so as to reallocate interest deductions to foreign source and away from U.S.-source income. This unfair rule was proposed to be changed by §864(f), which was postponed several times, and finally the rule was repealed permanently just this year.

[5] Had Congress understood the difference and considered adopting the exemption method for GILTI, it would have been forced to do the same for branch income. Of course, it did the opposite by creating a new foreign branch basket for FTCs. This is one reason (there are others) why referring to the TCJA's international rules as ''territorial'' is simply wrong.

[6] The significance of the 13.125% is that after the 20% cutback, it translates to the GILTI implied top marginal rate of 10.5%, which in turn is 50% of the top corporate rate of 21%. The math engendered by the 80% haircut continues to be poorly understood by policymakers. For example, the Senate Finance Framework states: ''Even when trying to create a matching pair with GILTI and FDII, the architects of the 2017 tax law could not help but put the thumb on the scale for offshoring income, by making the GILTI rate (10.5 percent) lower than the FDII rate (13.125 percent).'' The rate difference does not operate as a thumb on the scale; it is simply a function of the 80% cutback on FTCs. The error here, again, is the failure to understand how the FTC rules operate.

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foreign-source income in the GILTI basket and reducing the associated FTCs.[7]

The design of the GILTI FTC basket, coupled with the TCJA's abandonment of the multi-year approach to FTCs adopted in 1986, virtually ensured that GILTI would be subject to international double taxation far in excess of what Congress evidently believed. Faced with these patently unfair results and conscious that this was not what Congress had in mind, Treasury and the IRS got creative and crafted the so-called high-tax exemption from GILTI. Without going into detail here, it is sufficient to note that the high-tax exemption is both extraordinarily complex and unlikely to provide relief to many if not most U.S. shareholders of CFCs.

The Biden administration's international tax proposals would do nothing to fix the mistake made by failing to adopt an exemption system for active income of CFCs or even to fix the broken FTC rules applicable to GILTI. On the contrary, the proposals would compound the mistakes created by the TCJA's conflation of the distinct subpart F and GILTI architectures. The administration's proposals do this by, among other things, increasing the GILTI tax rate and adding a country-by-country calculation of FTCs, without changing the rule that a loss CFC forfeits all FTCs with no carryforwards. It is unclear how the FTC rules that require allocation and assignment of income and taxes will apply in a country-by-country context, especially where there are intercompany and/or branch transactions. It is also unclear whether a loss suffered by a CFC in one country can be applied to reduce the income of a CFC in a different country. Finally, the Biden proposals would repeal Treasury's high-tax exception from GILTI, further increasing the likelihood of double international taxation. Taken together, the Biden administration proposals are like adding additional stories to a building that is cracking at the foundation.[8]

The Senate Finance Framework, while marginally more promising than the administration's proposals, similarly fails to come to terms with the problems created by applying the Code's FTC rules to active income fully subject to international double tax. The first part of the Framework utterly ignores even the existence of foreign taxes, for example by referring to the QBAI carve-out from GILTI as giving U.S. taxpayers "the ability to earn tax-free foreign income," as if the United States was the only country in the world to have a claim to tax U.S. persons. The second part buys into the FTC method as if there were no alternative choice and tries to fix it by suggesting a high-tax exemption bucket. But this approach simply kicks the can down the road: How do we determine whether the foreign rate is at or above the GILTI rate? If the proposal is to continue using the broken FTC rules, using U.S. tax principles on an annual basis, ignoring loss corporations, allocating deductions as if money were fungible, and disallowing carryforwards, this become an entirely meaningless exercise. Other countries avoid these pitfalls by looking at headline rates.

With this background in mind, let us turn to the OECD's proposal to adopt a worldwide minimum tax regime. There are many interesting technical questions that arise with respect to the manner in which the existing GILTI regime could be made to work together with a global minimum tax. But for present purposes we are less interested in those technical issues than in the basic design issue, which is how a GILTI regime that uses FTCs rather than an exemption method to avoid undue double taxation across borders can fit within a global minimum tax regime that almost certainly needs to be based on a mutual exemption system.

To the extent that a particular country is permitted to tax the income of a CFC, and does so at a rate above the minimum rate, it would not make sense to impose GILTI. Put another way, if the United States insists, as it traditionally has, on imposing residual tax on the income of U.S. shareholders of CFCs, and uses the FTC regime with its requirements to calculate income based on U.S. tax principles, double taxation will invariably result. Almost all developed countries employ an exemption system to refrain from taxing active income earned by CFCs, as well as branches.[9]

There is also the question of what to do about subpart F. Many countries do not have rules similar to

[7] The Senate Finance Framework refers to this error only in the context of R&D deductions, leaving in place the fundamental error of applying an FTC approach.

[8] Other aspects of the Biden administration proposals, such as applying §265 to deny deductions for expenses allocable to income that is wholly or partially deductible under §245A or §250, have the flavor of rifle-shot provisions uncoordinated with any coherent international tax policy. *See* Noren, *Section 265 and the U.S. Non-Territorial Territorial System*, 50 Tax Mgmt. Int'l J. 361 (July 2, 2021). If the proposals were to adopt an exemption system for active income, including active income of branches, then a rule like §265 would at least be understandable. Even then, its complexity might not be worth the candle, especially when layered on top of the "SHIELD" and interest deduction disallowances. To address this problem, the Camp proposal would instead have imposed a 5% haircut on the exemption.

[9] It is often said that the TCJA enacted a "quasi-territorial" system because it permits the tax-free repatriation of CFC earnings after allowing an exclusion from GILTI for a deemed return on active assets. Even if this were a correct characterization of the current system, which it is not, the Biden proposals would eliminate the exclusion just mentioned. The United States stubbornly remains the only large country to impose worldwide taxation, including on all branch income.

subpart F, and those that do would presumably need to adjust their systems to account for a global minimum tax. Notably, the Biden administration proposals would not change the manner in which subpart F works. This leaves unanswered many questions about how subpart F inclusions would interact with a new global minimum tax.

To address the new global minimum tax regime, if in fact the United States is serious about it, U.S. tax law must be redesigned. There are a number of different designs that could be considered, but at a minimum any design chosen should be based on enduring and coherent principles. It should abandon the traditional insistence of the United States to tax all residual income earned outside its borders, should adopt an exemption method for active income, and should limit the FTC method to passive and easily mobile income. It should also be relatively simple, so that taxpayers, government tax auditors, and policymakers have some basis on which to understand it. The law in this area today is the opposite of all these things, and the current proposals to change it would only make it worse.

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