International Tax Reform Framework Discussion Draft

Section-by-section description

Comments on this discussion draft are requested. Please send any comments to InternationalTax@finance.senate.gov by September 3, 2021.

Sec. 1 Modifications relating to net CFC tested income

Section 951A is renamed "Country-by-country global inclusion of low-tax income."[1]

Repeal of exemption for ten-percent deemed return on qualified business asset investment.

Sec. 1(a) addresses changes to the amount included under GILTI. It repeals provisions that provide that global intangible low-taxed income is the excess of net CFC tested income over the net deemed tangible income return. This has the effect of repealing the tax exemption for the ten-percent deemed return on qualified business asset investment (QBAI) owned abroad.

Application of country-by-country high-tax exclusion in GILTI.

Sec. 1(b) provides for a country-by-country system applied to GILTI. It does so through a high-tax exclusion modeled on regulations issued by the Treasury Department in 2019 and 2020, and creates a country-by-country system that functionally operates as a top-up tax. It also prevents losses incurred in one country from being used to offset income in another. In the new GILTI high-tax exclusion, if a taxpayer earns income in a foreign country that is subject to an effective tax rate that is above the GILTI rate, it is treated as high-tax income and is generally not subject to residual US tax. If the taxpayer earns income in another foreign country that is subject to an effective tax rate that is below the GILTI rate, the income is subject to a top-up tax that at least brings the total taxes on the income from that country up to the GILTI rate.

Under new section 951A(b)(2)(A)(i)(VI), income that otherwise would be included as tested income in GILTI would be excluded if it is "high-tax tested income."

New section 951A(e) defines high-tax tested income. Income is treated as high-tax tested income if it would otherwise be taken into account under GILTI, but faces an effective rate that is (after incorporating any foreign tax credit haircut) greater than the GILTI rate.[2]

Whether income is high-tax tested income is determined on a country-by-country basis.[3] The unit of measure for determining the effective tax rate is a "tested unit," which includes controlled

[1] While the income inclusion under revised section 951A is net CFC tested income (and no longer global intangible low-taxed income), the overall regime may still be referred to as GILTI ("global inclusion of low-tax income").

[2] If the foreign tax credit haircut is 20 percent, then only 80 percent of taxes paid are used in determining the effective rate under the high-tax exclusion. This is necessary to create some parity between taxpayers just below and just above the GILTI rate. If a haircut is applied for GILTI but not for the high-tax exclusion, taxpayers with rates just below the GILTI rate would face notably different tax impacts than with rates just above the GILTI rate, even if their effective tax rates are quite close.

[3] It is anticipated that this would technically be applied on a jurisdiction-by-jurisdiction basis.

foreign corporations (CFC), foreign branches owned by a CFC, and interests in certain pass-through entities held by a CFC. When a CFC operates in multiple countries, the operations outside of its country of tax residence would be branches or other separate interests, and each branch or interest would be a distinct tested unit from the operations of the CFC in the country of tax residence.[4] Since a taxpayer could potentially have many tested units in a single country (each referred to here as a "separate tested unit"[5]), all separate tested units that are in the same CFC and in the same country are aggregated into a single tested unit. Additionally, all separate tested units in the same country that are members of the same expanded affiliated group are aggregated into a single tested unit. For a multinational corporation, this aggregation would generally lead to all of the operations in a country treated as a single tested unit, creating a country-level determination for high-tax tested income.

No tested units that are in different countries can be aggregated. For example, if a CFC were incorporated in Country X, and also had a branch in Country Y, the CFC's country X operations would be one tested unit, and the Country Y branch would be a second tested unit. As the two tested units are in separate countries, they are not aggregated for purposes of the high-tax exclusion.

Income which is treated as high-tax tested income is excluded from the GILTI system, but is not technically exempted from tax at that point. Since this income is not included as net CFC tested income, inclusion of that income would technically be deferred until the income was repatriated to a US taxpayer. Presuming it otherwise meets the requirements of the dividend exemption system under section 245A, it would be exempted through an additional deduction at the time of repatriation, leading the high-tax tested income to be functionally exempt from US tax.

A tested unit that has a tested loss is also treated as creating high-tax tested income. Since the effective tax rate on a loss may result in either a negative effective rate or an undefined value, a special rule is necessary to determine the proper treatment. Keeping tested units with losses in GILTI, rather than excluding them, could lead to the potential for the country-by-country system to falter by allowing losses from typically high-tax countries to offset income from low-tax countries.[6] The aggregation rules for tested units also applies for losses, so a tested unit with losses is only treated as a high-tax tested unit if there is a loss once all aggregation rules have been applied.[7]

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[4] For example, if a Japanese CFC also has operations in South Korea, the South Korean operations would be a branch, and therefore would create a distinct tested unit.

[5] This is not a term in the statute, but is used to help distinguish operations which would be their own tested unit, if not aggregated into a larger tested unit.

[6] For example, a $100 loss could occur in a typically high-tax country such as Germany. If that loss is not excluded from GILTI and the same company has $100 of low-tax income earned in Ireland, then the German loss would offset the Irish income, for a net $0 in GILTI.

[7] For example, separate tested unit Gamma in Spain has a loss of $5. Separate tested unit Epsilon in Spain has income of $10. Both Gamma and Epsilon are owned by the same CFC and are aggregated into a single tested unit. The income of the tested unit is $5, and it is not treated as having a tested loss. Gamma is not excluded under the tested loss rule because it is part of a tested unit which does not have a loss.

Since the income that is treated as high-tax tested income is not subject to US tax, any foreign income taxes properly attributable to this income are not creditable or deductible.

After application of the high-tax exclusion, GILTI would essentially operate for tested income that is not excluded as it does under current law. Net CFC tested income would be included currently and be eligible for a reduced rate of tax through the section 250 deduction, and the US tax could be reduced through the application of foreign tax credits, subject to existing limitations.

The exclusion of the high-tax tested income from net CFC tested income, as well as the treatment of a tested unit with losses, means that the only income that is subject to the GILTI current inclusion system is low-tax income – i.e., foreign income that has not faced an effective tax rate of at least the GILTI rate, when tested at the country level. When including only low-tax income in the current inclusion system, the result is that each country-inclusion is subject to a top-up tax that brings the total tax rate in each low-tax country – including both foreign and US taxes – to at least the GILTI rate. By excluding any income which has faced effective country-level tax rates that are greater than the GILTI rate, any potential excess credit from one country that may reduce this top-up tax in another is excluded from the system.[8]

Timing issues.

The drafters are considering the best way to address timing issues in the country-by-country high-tax exclusion. For example, how losses in one year may impact the tax on income in a succeeding year. Special rules dealing with timing should operate within the architecture of the high-tax exclusion described above, and retain the country-by-country purpose that prevents losses in one country from offsetting income in another.

Application of deemed paid credit, reporting, and effective date.

Sec. 1(c) updates the foreign tax credit rules for inclusions of net CFC tested income. The status of the foreign tax credit haircut remains under consideration, and could be anywhere from zero to 20 percent. In order to reflect the country-by-country system that the high-tax exclusion creates, taxes paid in countries that are neither high-tax nor in a loss position are creditable. Meaning that, even if a CFC has a tested loss after application of the high-tax exclusion, foreign income taxes properly attributable to amounts taken into account in determining that CFC's tested loss will be treated as tested foreign income taxes.[9] In order to coordinate GILTI with non-US minimum taxes, Treasury is authorized to give priority to ultimate parent countries.[10]

[8] Different country-by-country systems achieve the same purpose – keeping any excess credit created in one country from reducing the top-up tax on income from another country. Under the high-tax exclusion, that is achieved by excluding any income (and the related taxes) which may create an excess credit. Under systems that would use separate foreign tax credit baskets for each country, that is achieved by excluding excess credits from the system while keeping all the income in the system. The end results are essentially the same.

[9] A CFC with a tested loss is only included in net CFC tested income if that loss arises from a country that has positive income overall, so the tested loss of a CFC is combined with other separate tested units in the same country, to create a tested unit which has net income.

[10] As home to the most large multinational companies, priority for ultimate parent countries is beneficial to the US if other countries also implement minimum taxes.

Section 1(d) includes a reporting requirement to report the income and effective tax rates of each tested unit. Section 1(e) sets the effective date.

Sec. 2 Modifications to subpart F income

Sec. 2 updates subpart F to more closely align the mechanics of subpart F with the mechanics of GILTI.

<u>Alignment of subpart F and GILTI foreign tax credit rules.</u>

Sec. 2(a) updates foreign tax credit rules under subpart F. To the extent that there is a foreign tax credit haircut in GILTI, there will be a similar foreign tax credit haircut in subpart F. The foreign tax credit haircut is also extended to previously taxed earnings and profits so that withholding taxes and net income taxes are treated similarly. As with GILTI, the extent of the haircut is still to be determined, and could be anywhere from zero to twenty percent.[11]

<u>Application of country-by-country high-tax exclusion system to subpart F.</u>

Sec. 2(b) applies the high-tax exclusion in GILTI to subpart F, in order to more consistently apply the tax rules on foreign income. After such change, the only substantial differences between the GILTI high-tax exclusion and the subpart F high-tax exclusion are: 1) the relevant type of income and 2) the tax rate.

The subpart F high-tax exclusion is applied to income that would otherwise be treated as foreign base company income or insurance income. While the existing high-tax exception under section 954(b)(4) applies separately for each item of income, for purposes of the high-tax exclusion, different items of income are aggregated.[12] In order to prevent inappropriate blending, income that would be in the passive foreign tax credit basket should be separated from income that would be in the general foreign tax credit basket for purposes of the high-tax exclusion. The tax rate used to determine the subpart F high-tax exclusion is the corporate rate.

The rules for the subpart F high-tax exclusion are the same as the rules for the GILTI high-tax exclusion, including the use of the tested unit, the aggregation rules, and the rules for losses.

Under the rules for tested income in GILTI, income that would have been subpart F income but for section 954(b)(4) is not treated as tested income for purposes of GILTI. So the income excluded from subpart F under the high-tax exclusion is also excluded from GILTI, preventing blending between subpart F income and GILTI income.

[11] The foreign tax credit haircuts applied to subpart F and GILTI can be, but do not necessarily have to be, the same. The same applies for the foreign tax credit haircut applied to branches, discussed below.

[12] For example, by an item of income test, foreign base company sales income and insurance income would each be examined separately. Under the subpart F high-tax exclusion, foreign base company sales income and insurance income that are earned by the same tested unit would be aggregated.

Sec. 3 Exclusion of high-tax income of foreign branches

Sec. 3 extends the high-tax exclusion rule to foreign branches in order to apply the rules for foreign income consistently across types of foreign income. Since branch income is earned directly by a US corporation, rather than through a CFC, it operates with some distinctions from the high-tax exclusions for GILTI and subpart F.

Under new section 139J, high-tax foreign branch income earned by a US corporation is exempt from tax. Income is treated as high-tax foreign branch income if it is subject to a tax rate greater than the corporate rate or greater than the highest individual rate for taxpayers that are not corporations.

As with the GILTI and subpart F high-tax exclusions, the high-tax foreign branch exclusion is tested at the country level, with branches in the same country being aggregated, and foreign tax credits potentially subject to a haircut of zero to twenty percent. While branches that have losses are not treated as creating high-tax foreign branch income (a distinction with the GILTI and subpart F regimes), no foreign tax credits are allowed from branches with losses.

Sec. 4 Allocation of research and experimental and stewardship expenses

Sec. 4 amends the foreign tax credit limitation rules for certain expenses if activity is conducted in the United States. Specifically, for purposes of determining the foreign tax credit limitation, expenses for research and experimentation and for "stewardship" would be treated as 100 percent allocated to US source income if those activities are conducted in the US. Stewardship and research and experimentation activities that are performed outside the US would be treated as they are under current law.

Sec. 5 Modifications to deductions for foreign-derived innovation income and net CFC tested income

<u>Increase of GILTI and FDII rates</u>.

Sec. 5(a) reduces the section 250 deduction for net CFC tested income (i.e., income earned in GILTI) and for foreign-derived innovation income (formerly foreign-derived intangible income). The amount of the deduction is still to be determined. The section 250 deduction for GILTI and FDII is equalized.

<u>Deduction for foreign-derived innovation income</u>.

The current definition of deemed intangible income is replaced with "domestic innovation income." Domestic innovation income is an amount equal to the sum of [TBD] percent of qualified research and development expenditures plus [TBD] percent of qualified worker training expenses. To be a qualified expense in these categories, the expense must be for domestic activity. If deduction eligible income is less than this total, then domestic innovation income is reduced to the amount of deduction eligible income.

The foreign-derived ratio calculation remains unchanged. The amount of FDII, if put into equation form, would be:

$$domestic\ innovation\ income\ \times foreign\ derived\ ratio$$

$$[lesser\ of\ DEI\ or\ (TBD\% \times R\&D\ expense + TBD\% \times\ training\ expense)]\ \times (\frac{FDDEI}{DEI})$$

Qualified research and experimental expenditures are those expenditures that are eligible to be deducted under section 174,[13] and that are conducted in the US. Qualified training expenditures are expenditures that result in the attainment of a recognized postsecondary credential and are for the qualified training of a non-highly compensated employee.

Sec. 6 Modification to tax on base erosion payments

Restoration of full value to domestic business credits.

The domestic business credits under section 38 are provided full value in the base erosion and anti-abuse tax (BEAT). This is accomplished by providing that all section 38 general business credits do not reduce the regular tax liability for purposes of determining the base erosion minimum tax amount.

Addition of second rate bracket for base erosion income.

A second, higher rate of [TBD] percent is added to BEAT system, in determining the base erosion tax liability. The higher bracket would apply to "base erosion income," which is the amount of income added to taxable income under section 59A(c)(1) to determine the modified taxable income. Regular taxable income, excluding base erosion income, remains subject to the 10 percent rate in the BEAT equation. So, base erosion income plus regular taxable income would be equal to the current law modified taxable income. As with current law, the rates on base erosion income increase by 2.5 percentage points after 2025.

If shown in an equation, base erosion tax liability would be:

$$(10\%\ \times\ regular\ taxble\ income) + (TBD\%\ \times base\ erosion\ income)$$

SHIELD

The drafters are considering the best way to incorporate into the BEAT the purposes and policies of the Stop Harmful Inversions and Ending Low-Tax Developments (SHIELD) proposal put forth by the Biden administration.

[13] If research expenses are required to be amortized, the research expense for purposes of domestic innovation income would be the deduction amount as if amortization was not in effect.