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DEBATE ON THE US TAX REFORM AND THE EU ATAD

Can GILTI + BEAT = GLOBE?

Mindy Herzfeld*

The OECD is moving forward with consideration of a minimum tax as part of its solution to taxation of the digital economy. Part of a template for such a minimum tax may be the version enacted by the United States (US) in 2017 as an expansion of its Controlled Foreign Corporation (CFC) regime, known as Global Intangible Low Taxed Income (GILTI). But the OECD version will undoubtedly be different from the US iteration. It's likely that it would also include some aspects of a minimum tax being proposed by other OECD members such as Germany and France, namely a tax on outbound payments, in addition to a CFC-type regime. The United States also enacted an outbound minimum tax in 2017, known as Base Erosion Anti-Abuse Tax (BEAT). The two-part minimum tax being pursued by the OECD – a minimum tax based on a CFC regime plus an outbound minimum tax that's a variation on the BEAT – has been referred to as GLOBE (global anti erosion) (See S. Soong Johnston, Germany, France Explore GLOBE Proposal to Tax Digital Economy, 92 Tax Notes Int'l 782 (2018)).

This article summarizes the two features of the US 2017 tax reform (known as the Tax Cuts & Jobs Act (TCJA) (The formal name is The Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115–97.)) that may be incorporated into a global minimum tax, namely GILTI and BEAT, from the perspective of how such provisions might be adapted to work in a global setting. It considers the challenges to taxpayers and policy makers raised by the US law as enacted, and the attempts in recently issued regulatory guidance to address some of these concerns. It compares and contrasts the provisions enacted by the US Congress with a number of parallel European developments, including the EU Anti-Tax Avoidance Directive (ATAD)'s CFC rules and the German royalty deduction barrier.

Adaption of the minimum tax components of the Tax Cuts & Jobs Act for worldwide use will require careful understanding of the policy choices, as well as the mistakes made, by the TCJA drafters in designing the regime, in order to ensure that they are not repeated.

I FROM A CFC REGIME TO A MINIMUM TAX?

I.1 ATAD CFC Rules

In 2016 the EU agreed on a council directive including a number of tax anti-avoidance measures that member countries are required to implement.¹ The directive, generally known as ATAD, obligates countries to implement various anti-avoidance measures, including CFC rules, which are supposed to be effective by the beginning of this year.

The CFC rules are described in Article 7 of the Directive, which gives member countries a choice between two alternative CFC regimes, both of which are specifically targeted at tax avoidance. As a threshold matter, paragraph 1 of Article 7 sets out the conditions under which the CFC regime will apply. It requires Member States to treat an entity (or a non-taxed permanent establishment) as a controlled foreign company of a resident

taxpayer in situations where both of the following conditions are met: (a) the taxpayer (either by itself or together with its associated enterprises) holds a direct or indirect participation of more than 50% of the voting rights, capital, or profits of an entity; and (b) the actual corporate tax paid on its profits by the entity (or permanent establishment) is lower than the difference between the corporate tax that would have been charged by the Member State of the taxpayer and the actual corporate tax paid.

Paragraph 2 of Article 7 sets out two alternative ways in which member countries can design their CFC regimes. Under the first alternative, once an entity qualifies as a CFC of a taxpayer, the taxpayer's Member State includes in the tax base certain specified types of income, namely:

- (i) interest or any other income generated by financial assets;
- (ii) royalties or any other income generated from intellectual property;

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¹ EU Anti-Tax Avoidance Directive (ATAD): Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L193/1 (19 July 2016).

- (iii) dividends and income from the disposal of shares;
- (iv) income from financial leasing;
- (v) income from insurance, banking and other financial activities;
- (vi) income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value.

There's a significant exception to this general rule, which would otherwise appear to require immediate inclusions of income of passive or mobile income of a CFC into the shareholder's current taxable income, similar to US subpart F rules. No inclusion is required in situations in which the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances. The directive also says that where the CFC is located outside the EU, this exception need not apply.

Member States can allow for two other exceptions to this CFC regime – they can opt not to treat an entity as a CFC if one third or less of the income accruing to the entity is of the 'bad' types of income. Member States can also opt not to treat financial undertakings as CFCs if one third or less of the entity's income from the 'bad' categories comes from transactions with the taxpayer or its associated enterprises.

Under the second alternative, the taxpayer's resident state looks to whether the non-distributed income of the CFC arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. The directive says that an arrangement or series of arrangements is regarded as non-genuine to the extent that the entity or permanent establishment would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions which are relevant to those assets and risks are carried out and are instrumental in generating the controlled company's income.

If adopting this second alternative, Member States can exclude from the scope of the regime entities with accounting profits of no more than EUR 750,000 and non-trading income of no more than EUR 75,000; or entities that have accounting profits of no more than 10% of their operating costs.

As this brief summary of the ATAD's guidance on CFC regimes indicates, the EU is uniquely focused on tax avoidance in designing the guidelines for Member States for this purpose. For example, under the first

alternative – which targets passive income – the regime may only apply when there is no substantive economic activity taking place. And under the second approach, sometimes referred to as the 'transfer pricing' approach – the EU is focused on a CFC's profits that may be better described as properly attributable to the parent's activities, as well as the purpose of obtaining a tax advantage.

Many EU member countries have chosen the less restrictive choices for enacting CFC regimes. Ireland, for example, has introduced CFC rules that adopt the second approach, attributing to the parent company undistributed income of the CFC that arises from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage.² Belgium, in adopting its CFC rules, followed a similar approach.³ And Luxembourg made a similar choice in its initial adoption of CFC rules.⁴

1.2 GILTI

GILTI, which can be characterized as a significant expansion of the US CFC regime, has but a few points of similarity with the EU ATAD's CFC guidelines. If the GILTI minimum tax concept is expanded to include all OECD members, including EU member countries, the following parallels and variances will need to be considered and addressed.

1.2.1 Ownership Threshold

One of the few parallels between the GILTI regime and the EU's CFC rules is the threshold at which they become relevant – both require a 50% ownership stake by the resident taxpayer before the rules begin to apply. But there the similarity ends. For even with a 50% ownership stake, the ATAD CFC rules only apply if there is a significant disparity between the tax rate of the 50-percent-owned entity and the resident taxpayer. The US GILTI regime, in contrast, explicitly does not require an analysis of the foreign effective tax rate before it applies (although the foreign tax rate is implicitly relevant by virtue of the fact that the US resident taxpayer is allowed a foreign tax credit against inclusions of GILTI).

Even the 50% ownership threshold – in theory one of the simplest aspects of the US CFC regime – has raised numerous interpretive questions in the United States. Regulations issued by the IRS and Treasury in September try to address some of these questions, such

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² See IE: Explanatory Memorandum to Ireland Finance Bill 2018, <https://data.oireachtas.ie/ie/oireachtas/bill/2018/111/eng/memo/b11118d-memo.pdf> (accessed 31 Jan. 2019).

³ See Loyens & Loeff, The Introduction of CFC Legislation in Belgium (29 Dec. 2017), <https://www.loyensloeff.be/en/news/the-introduction-of-cfc-legislation-in-belgium/> (accessed 31 Jan. 2019).

⁴ See PwC Luxembourg, *ATAD 1 – Luxembourg Parliament Votes to Approve Transposition into Luxembourg's Tax Laws* (19 Dec. 2018), <https://www.pwc.lu/en/newsletter/2018/atad1-tax-laws.html> (accessed 31 Jan. 2019).

as how to apply existing subpart F rules that provide guidance to taxpayers as to how to allocate a CFC's subpart F income among different shareholders, to shareholders' calculations of GILTI.⁵

For example, under the pre-TCJA subpart F regime, enacted in the 1960s, the US regulations have applied robust and complex rules for determining the timing of a shareholder's inclusion of subpart F income, and how much of the subpart F income of a CFC a shareholder should include into taxable income when, for example, a CFC has more than one owner, or more than one class of shares outstanding. But these rules needed revision to work for the GILTI regime. That's because while subpart F is solely an entity (CFC) level calculation, GILTI requires a netting of different CFCs 'tested income' and 'tested losses' at the US shareholder level (as discussed in greater detail below).⁶ On this point, the proposed regulations provide that the rules in the current regulations (which require a pro rata allocation of subpart F income)⁷ generally apply, with modifications to account for the differences between subpart F income and the GILTI regime. The proposed regulations also address questions taxpayers had been asking about how to calculate GILTI inclusions in the case of CFCs owned through partnerships, or where shareholders own preferred stock in the CFC.⁸ Similar to the determination of a US shareholder's pro rata share of subpart F income, for example, Prop. Reg. § 1.951A-1(d)(1) provides that a US shareholder's pro rata share of any item of income of a CFC item necessary for calculating its GILTI inclusion amount is determined by reference to the stock the shareholder owns as of the close of the CFC's taxable year, including stock treated as owned by the US shareholder through a domestic partnership.

Because the GILTI rules also require an allocation of losses from CFCs with 'tested losses,' rules are required to tell taxpayers how to perform these allocations as well. On this point, the proposed regulations provide that in general, the tested loss is distributed solely with respect to the CFC's common stock.⁹ But in cases where the common stock has no liquidation value, the proposed regulations provide that any amount of tested loss that would otherwise be distributed in the hypothetical distribution to the class of common stock is instead distributed to the

most junior class of equity with a positive liquidation value to the extent of the liquidation value.¹⁰ This raises more questions – what happens in future years, when the same CFC has tested income, and how to allocate such tested income among the different classes of stock.¹¹ These and other modifications of prior subpart F allocation rules are intended to ensure that the tested loss of a CFC is allocated to each US shareholder in an amount commensurate with the economic loss borne by the shareholder by reason of the tested loss.

The calculation of GILTI also requires a calculation and allocation of what the statute refers to as 'tested interest expense' and 'tested interest income;' in order to help taxpayers apply these rules, Treasury and the Internal Revenue Service (IRS) had to develop rules providing taxpayers with guidance as to how to perform these new calculations as well. Prop. Reg. § 1.951A-4 defines tested income, and Prop. Reg. § 1.951A-1(d)(5) and (6) provide rules for determining a shareholder's pro rata share of 'tested interest expense' and 'tested interest income.'

As the above summary of some of the questions addressed by new proposed regulations indicates, the new GILTI regime enacted by the US is not a simplification of prior subpart F rules. Making these rules work for a larger group of countries could be a challenging exercise.

1.2.2 Tax Rate Threshold

As mentioned above, the US GILTI regime does not explicitly factor in the foreign tax rate in the determination of whether the rules apply; instead, every foreign subsidiary is potentially subject to having its earnings included as GILTI. Nonetheless, the GILTI regime does effectively take the foreign tax rate into account because (with a big caveat) it will only subject to additional US tax foreign income that is taxed below a certain rate, due to the existence of the US foreign tax credit.¹² In theory, the GILTI regime would only apply to tax foreign earnings of subsidiaries that are subject to a domestic tax rate of below 13.125%. That number is a function of two features of the GILTI regime: (i) the US rate imposed on GILTI earnings (equal to ½ the US standard corporate rate of 21%) and (ii) the fact that the US foreign tax credit

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⁵ US: REG-104390-18; 2018-43 IRB 67.

⁶ US Code s. 951A(c).

⁷ US: Treas. Reg. § 1.951-1(b) and (e).

⁸ US: Prop. Reg. § 1.951A-1(d)(2). For a thorough list of questions raised by taxpayers on how to interpret the GILTI statutory provisions, see New York State Bar Ass'n Tax Section, *Report on the GILTI Provisions of the Code*, Report No. 1394 (4 May 2018), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Reports_2018/1394_Report.html (accessed 31 Jan. 2019).

⁹ US: Prop. Reg. § 1.951A-1(d)(4)(i) – (iii).

¹⁰ US: Prop. Reg. § 1.951A-1(d)(4)(iii).

¹¹ US: Prop. Reg. § 1.951A-1(d)(2)(ii).

¹² See US Code ss 901, 904, and 960.

on GILTI earnings is limited to 80% of foreign taxes paid on those earnings.

This principle is not truly sound, however, once some other features of the US foreign tax credit regime – as revised by the TCJA – are considered. The US foreign tax credit has always operated to limit a taxpayer's ability to claim the credit to – very simplistically – the US tax rate that would be imposed on the taxpayer's foreign earnings, a principle known as the foreign tax credit limitation. And in order to prevent taxpayers from using high taxes paid on active earnings to offset lower taxed passive earnings, this limitation has applied by way of a set of 'baskets'. Immediately prior to passage of the Tax Cuts & Jobs Act, there were two baskets (at various times in the history of the foreign tax credit there have been up to nine baskets), a passive basket and a general basket. The TCJA introduced two new baskets, the foreign branch basket and the GILTI basket. As a result, taxes paid on earnings that are includible in income of the US shareholder as GILTI can't be credited against taxes paid on other types of foreign earnings, and vice versa. Furthermore, taxpayers are not allowed to fully credit taxes paid on GILTI earnings, but only 80% of such taxes paid. And to add another twist, foreign taxes attributable to GILTI earnings can't be carried forward or back if not fully utilized in the year of the inclusion. In other words, taxpayers either have enough GILTI earnings to soak up any credits for taxes paid on GILTI earned in the current year, or such credits are lost.

The US foreign tax credit rules add another nuance that make the limitation system even more complicated to apply. They require that some types of shareholder level expenses – the most common one being interest, but also R&D, be allocated not just to the jurisdiction where incurred (i.e. the United States), but to the calculation of foreign source earnings as well.¹³ In other words, if a US corporation has USD100 of interest expense in the current year, and 100% of its earnings are foreign source, all of the interest expense is allocated against the foreign earnings. What this means is that even if the foreign jurisdiction imposed a 13.125% corporate income tax rate, there would be insufficient foreign earnings against which to fully credit (at an 80% credit allowance) the foreign taxes paid on those earnings. The IRS and the US Treasury have begun the process of trying to modify the old system of allocating deductions for foreign tax credit purposes to the new regime in a set of regulations that was released in December.¹⁴ The regulations required the Treasury to make a series of judgment calls concerning the fisc. As taxpayers clamoured for breaks in the expense allocation rules, Treasury's willingness to accommodate

these requests would translate directly into lower revenue from the GILTI regime.

The ATAD's CFC guidelines neither acknowledge nor anticipate any of the complexity of the type that is associated with the US foreign tax credit regime. But expanding the US CFC regime to encompass most headquartered companies' foreign earnings will necessarily put more pressure on determination of foreign tax rates. Questions of the type the United States has wrestled with in drafting the GILTI regime – and is still trying to resolve – will inevitably be raised.

1.2.3 Type of Income Earned

Under the first of two alternative CFC regimes permitted by the ATAD guidelines, the resident shareholder is required to include in income certain types of passive income earned by the CFC (as described in detail above). Most of these categories of passive, or mobile income closely resemble income that would generally be required to be included as foreign personal holding company income under US subpart F rules as in effect prior to enactment of the TCJA. However, the directive also allows member countries to incorporate important exceptions to application of this regime: for one, it says that this rule can be applied in a way so as not to require any inclusion when the CFC carries on a substantive economic activity supported by staff, equipment, assets and premises. Second, the directive says that countries can write the rules to say that companies won't qualify as CFCs if one third or less of the entity's income from the categories comes from transactions with the taxpayer or its associated enterprises. In other words, countries can write the rule to apply only to companies that don't carry on much substantive activities.

The GILTI regime, in contrast, mostly makes any analysis as to the type of income earned by the CFC irrelevant in the determination of whether there will be a GILTI inclusion. All income of the CFC, with a few enumerated exceptions, is considered 'tested income' and therefore potentially includible in the US shareholder's income as GILTI.¹⁵ Also not required is any calculation as to the extent the entity is engaged in substantive activity, or the percentage of income earned from passive or 'bad' transactions. The shareholder of a CFC with nothing but good active income could still be required to include its earnings into income on a current basis.

Nonetheless, the numerated exceptions to GILTI ensures that a calculation of whether the entity earns

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¹³ See generally US Code ss 861–65 and s. 904, and regulations thereunder.

¹⁴ US: REG-105600–18; 83 F.R. 63200–63266 (7 Dec. 2018).

¹⁵ The definition of 'tested income' generally means 'the gross income' of a CFC, with specific items of income excluded. See US Code s. 951A(c)(2)(A).

'bad' income remains necessary. One of the exceptions to 'tested income' is income that qualifies as subpart F income¹⁶; Subpart F income, while also taxed currently to the US shareholder, differs from GILTI inclusions in that it is taxed at the full statutory rate, and inclusions of subpart F income carry with them 100% of attributable foreign taxes paid. Income that is excluded from the definition of subpart F income because it is 'high-taxed income' under section 954(b)(4) is also excluded from tested income.¹⁷ High-taxed income is defined in the Internal Revenue Code as income subject to an effective foreign tax rate greater than 90% of the maximum US corporate tax rate, currently equal to 18.5%. Such exceptions to the definition of 'tested income' means that determination of the type of income earned by the CFC as well as the tax rate imposed on different items of income remains a relevant consideration for taxpayers attempting to calculate their GILTI inclusions.

The only way to remove such types of consideration from and thereby simplify the regime completely would be to no longer attempt to differentiate between passive income – generally categorized as easily shifted to low- or zero taxed jurisdictions – and active income. But doing so would run counter to competing goals, namely of ensuring that any comprehensive minimum tax regime was sufficiently robust in protecting against base erosion and profit shifting.

1.2.4 Subjective v. Objective Tests

The second option under the EU ATAD directive for member countries to utilize in implementing a CFC regime looks to whether the arrangement had a tax avoidance purpose. This option would impose tax on a base of income that arises from 'non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.' The directive provides guidance for when an arrangement is considered 'non-genuine,' explaining that arrangements are considered non-genuine 'to the extent' that the CFC wouldn't 'own the assets' or wouldn't have 'undertaken the risks' that generate all or part of its income, if it were not controlled by a company 'where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.' As such, this second option includes both a subjective

element – what was the taxpayer's purpose? And an objective one – to what extent is the CFC reliant on other group members' asset/employees in carrying out its activities?

The EU CFC guidelines are in sharp contrast to the GILTI regime on this point, which renders a tax avoidance purpose irrelevant. Also irrelevant under the GILTI regime is the question of the people functions undertaken by the CFC or other related parties, and questions as to whether any of those functions should be considered 'significant,' or 'instrumental,' or 'relevant' in generating specific items of income. In removing subjectivity and transfer pricing economic analysis from consideration, GILTI vastly simplifies a CFC regime and makes it much more robust in capturing all low-taxed income.

1.2.5 Exempted Return

One of the most complicating features of the GILTI regime results from the fact that it specifically doesn't attempt to include 100% of CFCs earnings into the shareholder's income. Instead, it builds in an exemption for a fixed (10%) return on the tangible (depreciable) assets of the CFC. The calculation required to compute the excess of a CFC's positive tested income over its return on fixed assets is extraordinary complex in part because it is performed at the shareholder level; this requires netting and adding of different CFCs' qualified business asset investment ('QBAI') on a consolidated level. Providing US parent companies with such an exemption was deemed politically and even economically necessary in the United States, and harks back to a 2013 proposal made by US Treasury economist Harry Grubert and Roseanne Altshuler of Rutgers University.¹⁸ In that article, in which Grubert and Altshuler proposed a minimum tax as a solution to the challenges facing the US international tax system, they also proposed allowing CFCs a deduction for 'real investment in the country' from the minimum tax base. Their goal was to tax only the excess return on CFCs' assets, and ensuring zero US tax on the CFC's normal return earned overseas. Similar proposals for exempting from variations on a minimum tax a 'normal' return on tangible assets were also included in proposals made by Republican members of Congress¹⁹ and by the Obama administration.²⁰

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¹⁶ US Code s. 951A(c)(2)(A)(i)(II). Unless otherwise noted, all 'section' references herein are to the Internal Revenue Code of 1986, as amended, and all 'Treas. Reg. §' references are to the Treasury regulations promulgated thereunder.

¹⁷ US Code s. 951A(c)(2)(A)(i)(III).

¹⁸ H. Grubert & R. Altshuler, *Fixing the System: An Analysis of Alternative Proposals for the Reform of International Tax*, 66 Nat'l Tax J. 671, 677 (2013).

¹⁹ See H.R. 1 – Tax Reform Act of 2014, 113th Cong., 2d Sess. (2014) and Jt. Comm. on Tax'n, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title IV – Participation Exemption System for the Taxation of Foreign Income*, JCX-15-14 (26 Feb. 2014).

²⁰ US: White House and Treasury, *The President's Framework for Business Tax Reform: An Update* (Apr. 2016).

In the GILTI regime, this exempt return is calculated as follows – each CFC’s investment in ‘good’ tangible assets – its Qualified Business Asset Investment – is determined.²¹ Then a return of 10% on each CFC’s QBAI is calculated. From this amount must be subtracted an amount of the CFC’s interest expense that’s relevant in determining the entity’s tested income for the tax year.²² The result – the Net Deemed Tangible Income Return – is a shareholder level attribute. But not all net deemed tangible income return (NDTIR) of each CFC is relevant for ultimately determining the shareholder’s GILTI. Only NDTIR from entities with positive tested income is taken into account in the GILTI calculation.²³

The exemption for a fixed return on tangible assets introduces multiple levels of complication. First, whether an individual item of property may qualify needs to be determined. Second, its basis needs to be calculated on a quarterly basis. Third, the calculation needs to be aggregated at the shareholder level. Both taxpayers and policy makers in the United States are beginning to question whether providing for this exemption is truly worth all the complications it introduces into the GILTI computation, given that the largest share of corporate profits is derived from intangible, rather than tangible, assets. In the United States, the exemption for NDTIR has also faced opposition from those arguing that it incentivizes taxpayers to invest in tangible assets overseas, rather than in the United States. To that end, a number of Democrats in Congress have introduced bills that would eliminate this exemption.²⁴

The EU CFC directive allows Member States to reflect a similar exception in their CFC regimes, providing that CFCs’ income can be excluded from the second alternative regime if their accounting profits amount to no more than 10% of operating costs for the tax period. But the GILTI regime is exponentially more complex in this regard.

1.2.6 Netting of Income and Losses

Most CFC regimes operate on a per-entity basis – an entity is either a CFC or its not, and its income is either includible or it’s not. The EU’s ATAD contemplates such a regime, and the US subpart F rules operate in that manner as well.

The GILTI regime discards the separate entity concept in several important respects. In calculating the GILTI inclusion, a shareholder’s net tested income – from all CFC’s with positive tested income – is aggregated at the shareholder level.²⁵ There, it is netted against any net tested loss – or the deficit in earnings of any CFCs with tested losses. The netting of CFCs with tested income against CFCs with tested losses somewhat mitigates the harshness of a minimum tax regime; without such netting, shareholders would be required to include in income currently the income of profitable foreign subsidiaries, with no allowance for losses incurred. But it also significantly complicates the regime, for a number of reasons. First, it requires a mechanism for determining how much of a CFC’s losses were utilized. Second, it means that other calculations – such as how much of a foreign tax credit is utilizable – must be determined at the shareholder level as well. Finally, it mandates the existence of a tracking regime for taxpayers to keep track how much of a CFC’s positive tested income was actually included at the shareholder level.

For countries without tax consolidation in their domestic laws, performing such a netting will be even more complex than it is in the United States. But an alternative for an expansion of a CFC regime into a minimum tax regime that also preserves the fundamental income tax principle of allowing profits to offset losses in a given tax year is not readily apparent.

1.2.7 Calculating the Minimum Tax

Yet another complicating feature of the GILTI regime is that it doesn’t simply impose a fixed rate of tax on the CFC’s tested income. Instead, in order to provide for a lower effective tax rate on foreign earnings, it allows for a deduction of 50% of GILTI income.²⁶ This again implicates the need for a shareholder level calculation, and the introduction of an entirely separate set of shareholder level complications into the regime – such as the interaction of the deduction for GILTI with the new interest expense limitation and deductions for net operating losses.

The EU ATAD directive appears to contemplate that the rate imposed on CFC income will be the same as the general statutory rate. But this is not necessarily an optimal path to follow when trying to impose a minimum tax

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²¹ US Code s. 951(d). Determining this amount requires analysing the tangible assets to determine whether they meet the threshold criteria of ‘specified tangible property,’ determining the basis of such assets, and determining the average of such basis at the end of each quarter of the tax year.

²² The effect of this formulation is to count against net deemed tangible income return only a US shareholder’s pro rata share of interest expense allocable to gross tested income to the extent that the related interest income is not also reflected in the US shareholder’s pro rata share of the tested income of another CFC, such as in the case of third-party interest expense or interest expense paid to related US persons.

²³ US Code s. 951A(b).

²⁴ See e.g. H.R. 5145, the Close Tax Loopholes That Outsource American Jobs Act, 115th Cong. (2018) introduced by Rep. Rosa L. DeLauro, D-Conn.

²⁵ US Code s. 951A(a), (c); Prop. Reg. § 1.951A-1(c)(2).

²⁶ US Code s. 250 (the deduction is reduced in 2026 to 37.5%).

on all foreign earnings. One important lesson from the US GILTI regime could be that simply imposing a lower rate of tax, rather than allowing a deduction, could significantly simplify the regime.

1.2.8 Previously Taxed Income

Finally, yet another serious complicating factor of the US GILTI regime is introduced by the feature that provides for the tracking of previously taxed income ('PTI').²⁷ The US subpart F regime had always had such a feature, necessary to ensure that undistributed profits that had previously been taxed at the US shareholder level wouldn't be taxed again when repatriated. To get a sense of the complexity of the US PTI rules, a quick review of Internal Revenue Service Notice 2019-01 is helpful; that notice provides new guidance for tracking PTI post-TCJA according to the rates at which such income was taxed, now accounting for two different tax rates provided for by section 965 (the one-time repatriation tax) in addition to rates on subpart F income and the lower rate on GILTI (as well as other categories). The US PTI rules haven't been updated substantially since first issued in the 1960s; although the IRS issued proposed regulations in 2006 to try and answer some questions that had been open for decades, these proposed regulations themselves raised so many questions that they were never finalized.

Although the system for tracking PTI was always seen as complex, it was also understood to be necessary in a tax regime where dividends paid to US shareholders from CFCs were subject to tax at the regular corporate rate; it was also less burdensome when the previously taxed profits of CFCs represented only a small portion of CFCs' earnings. Post-TCJA, where dividends from CFCs are entitled to a 100% dividends received deduction, it's less clear why such a system is really needed.²⁸

Nonetheless, both taxpayers and the Treasury and IRS see two important reasons why tracking PTI remains necessary: first, to ensure that withholding taxes payable upon distributions of PTI are creditable (the repeal of section 902 would otherwise preclude taxpayers from claiming any foreign tax credit upon the distribution of a dividend) and calculating and recognizing any fluctuation of currency exchange rates between the time of the inclusion and the time of distribution. But there are other mechanisms – undoubtedly simpler – that could be used for ensuring that credits associated with distributions of PTI are creditable, without having to track 16 different categories of PTI.

2 THE OUTBOUND MIN TAX

Adoption of a truly worldwide minimum tax cannot rely solely on a tax on resident shareholders of foreign entities in the form of a CFC regime. In order to protect against base erosion and against inversions – or headquarter companies decamping to the lowest taxed jurisdiction – an effective minimum tax at the source needs to be implemented. The US attempted a comprehensive approach to addressing outbound base erosion with enactment of the new BEAT rule, enacted in 2017 as section 59A of the Internal Revenue Code, which adopts a separate tax regime that subjects to additional tax all types of outbound deductible payments to related parties once certain specified thresholds have been met. But a simpler and less comprehensive version of an outbound tax has been implemented by Germany also in 2017, known as the royalty deduction barrier. Unlike the US approach, Germany's approach only targets a limited type of payments.

The proposal under consideration by the OECD will likely fall somewhere between the two different regimes in terms of comprehensiveness and complexity.

2.1 German Royalty Barrier

Effective 2018, Germany introduced a limitation on deductibility of certain royalty payments. Under this regime, deductibility of payments from a German company to a foreign related party is limited in cases where the payment benefits from a preferential regime not in compliance with action 5 of the base erosion and profit shifting (BEPS) action plan, which imposed a substantial nexus requirement on patent boxes that grants a preferential rate of tax on income derived from intellectual property.²⁹ The threshold for relatedness here is fairly broad, at 25% ownership stake, and the regime defines a harmful tax regime as one where the taxation of royalties differs from the general taxation of income in that jurisdiction, and the tax rate on royalty revenue is less than 25%. The limitation on deductibility doesn't apply in cases where the recipient's income is already subject to tax in Germany under Germany's CFC regime.

2.2 BEAT

GILTI and BEAT, which each constitute substantial modifications of the US international tax regime resulting from the TCJA, are in some respects mirror images of each other. While the GILTI can be characterized as a minimum tax on resident companies' foreign profits, the

Notes

²⁷ See e.g. US: IRS, Notice 2019-01, 2019-3 IRB 1.

²⁸ US Code s. 245A.

²⁹ See M. Greinert et al., *The Nexus Approach in Practice: Germany's New License Barrier Rule and Switzerland's Special Cantonal Tax Regimes*, 90 Tax Notes Int'l 339 (2018).

BEAT operates in a converse fashion, ensuring that US companies' domestic earnings are subject to a minimum level of tax. BEAT and GILTI are similar in that they both try to take the subjective element out of what have generally been designed as tax avoidance rules, by applying the tax once specific bright-line criteria have been met, regardless of a taxpayer's tax-avoidance purpose. Similarly, BEAT and GILTI both mostly disregard the character of income and the recipient's tax rate in determining whether the threshold for applying the tax has been met.

In many other respects, however, the new outbound tax enacted as BEAT is functionally different from the way GILTI operates. As explained in detail above, GILTI is mostly built on the existing edifice of the US subpart F regime, albeit that it introduces a myriad of new concepts that requires substantial fine-tuning of its rules to ensure compatibility with existing systems. BEAT, in contrast, introduces an entirely new calculation in the form of an alternative minimum tax that includes in its tax base otherwise deductible base eroding payments. Unlike GILTI, the entire set of rules that gives rise to the BEAT tax is fundamentally new and different from anything previously existing in the Internal Revenue Code as a tax on outbound payments. As a result, it required introduction of a whole new set of terms and calculations, each of which has given rise to interpretive questions and many of which don't function well within pre-existing rules. In part, the complications inherent in the BEAT are due to the fact that while US policy makers had been considering and analysing a minimum tax in the form of a CFC regime for close to a decade before enactment of the TCJA, the proposal for the BEAT, in contrast was sprung on the US business and policy community just six weeks before Congress passed the TCJA. The discussion below highlights just a few of the tensions and questions these new terms and required calculations have given rise to. Interpretation of these provisions will impose challenges on taxpayers and the Internal Revenue Service for years, if not decades, to come. And it may well be the case that the US Congress will need to step in to fix some of the most egregious errors involved.

The BEAT essentially functions by requiring taxpayers to calculate an alternative minimum tax base, on which is imposed a separate, additional, tax, to the extent that the taxpayer has met a threshold for base eroding payments (a defined term) to foreign related parties. To implement this tax, a number of new terms and concepts are required. For example, the BEAT only applies to an 'applicable taxpayer' whose gross receipts exceed a specified threshold (USD500 million). Even this seemingly simple test has given rise to numerous questions, in part because 'gross

receipts' is not a term that has previously had much relevance in the US tax system, which has mostly relied on concepts of taxable income rather than gross receipts. There is not a lot of case law interpreting this term. Other types of questions have arisen regarding application of this threshold test, such as: whose gross receipts matter? How does one calculate gross receipts in the case of payments made between persons who might be considered related? Should revenue generated by foreign persons count in determining whether the gross receipts test has been met? How to calculate gross receipts generated by a partnership in which a US company owns an interest? In proposed regulations issued last December, the IRS and the Treasury tried to provide some clarity to these terms for section 59A purposes.³⁰

For example, the term 'applicable taxpayer' as used in the statute isn't really utilizable by taxpayers attempting to apply the statute. That's because it seems to include foreign corporations generally and also doesn't account for payments between related domestic companies. To address these issues, the proposed regulations (Prop. Reg. §1.59A-2) define an applicable taxpayer as a corporation (other than certain specified corporations) treated as one person for purposes of determining whether a taxpayer satisfies the gross receipts test, and provide that foreign corporations will be treated as outside of the controlled group for purposes of applying aggregation rules (except to the extent that the foreign corporation has effectively connected income). Otherwise, according to the preamble to the proposed regulations, payments made to a foreign related corporation are not inappropriately excluded from the base erosion percentage test – a circular result that clearly would have been at odds with the statute. As Treasury's generous interpretation of the statutory language suggests, the statute as enacted was simply not workable on a standalone basis.

The proposed regulations clarify that payments between members of the aggregate group generally are not included in the gross receipts of the aggregate group, and are also not taken into account for purposes of the numerator or the denominator in the base erosion percentage calculation. But the proposed regulations also need to consider how to treat payments to a foreign corporation's US branch, which are not carved out by the statute. The result of not carving these payments out would have been that otherwise deductible payments made to a person that is subject to US corporate income tax would then be subject again to the BEAT minimum tax. To solve this problem, the proposed regulations explain that payments to a foreign corporation from within the aggregate group that are subject to net income tax in the United States are eliminated and not taken into account in applying the gross receipts test and the base erosion percentage test.³¹

Notes

³⁰ See US: REG-104259-18; 83 F.R. 65956-65997; 2019-2 IRB 300.

³¹ US: Prop. Reg. § 1.59A-2(e).

Similarly, the proposed regulations provide that in the case of a foreign corporation, the gross receipts test only takes into account gross receipts that are taken into account in determining income that is subject to net income tax as income effectively connected with the conduct of a US trade or business or in determining net taxable income under an applicable US income tax treaty.³²

What about if the group undergoes changes during the year? It would be rare for a large multinational company not to see at least a few members joining or leaving the group in any given year. The proposed regulations attempt to address that situation, providing that gross receipts of a taxpayer are measured by reference to the taxpayer's aggregate group determined as of the end of the taxpayer's taxable year for which BEAT liability is being computed.³³ Rules for computing gross receipts for entities that have been in existence for fewer than three years (the statute requires a look-back with an average of the three-year prior period) are also provided. Many challenging interpretive questions arise when there are entities taxable as partnerships, or flow-throughs, in a multinational group. The proposed regulations provide that if a member of an aggregate group owns an interest in a partnership, the group includes its share of the gross receipts of the partnership in its gross receipts computation, and that the aggregate group's share of the gross receipts of the partnership is proportionate to its distributive share of items of gross income from the partnership.³⁴

Once the gross receipts threshold has been met, the BEAT still won't apply unless a taxpayer's 'base erosion payments' paid to foreign related parties exceed a specified threshold amount (generally 3%, except for certain financial services companies, for whom the threshold is only 2%) – referred to as the 'base erosion percentage'.³⁵ What constitutes a 'base erosion payment' also requires definition, as does the denominator of the equation (generally defined as the taxpayer's tax deductions for the taxable year, but excluding certain deductions such as for net operating losses (NOLs), the section 245A deduction for foreign dividends, section 250 deductions for GILTI and foreign derived intangible income (FDII), certain payments for services, and deductions for certain qualified derivative payments). If all of these conditions have been met and the taxpayer is one to whom the BEAT applies,

the taxpayer is required to compute its 'modified taxable income' and then apply the BEAT tax rate (currently 10%) to the amount by which the modified taxable income exceeds the normal tax base.

Under the statute, the term base erosion payment is generally defined to mean any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable, and also includes any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer in connection with the acquisition by the taxpayer from such person of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).³⁶ An exception is provided for payments for services, in cases where the services are services that generally meet the requirements for eligibility for use of the services cost method under section 482, and the amount constitutes the total services cost with no markup component.³⁷

The statutory description of the payment for services exception gave rise to lots of questions as to its scope. If a payment for services exceeded the cost, was the entire payment invalidated as meeting the exception, or just the excess? The numbers at stake were significant, and the statute on its face appeared to invalidate the whole amount. The preamble to the proposed regulations noted that under one interpretation of section 59A(d)(5), the services cost method exception does not apply to any portion of a payment that includes any markup component. Under another interpretation, the exception is available if there is a markup, but only to the extent of the total services costs. Under the former interpretation, any amount of markup disqualifies a payment, in some cases resulting in dramatically different tax effects based on a small difference in charged costs. In addition, if any markup were required, for example because of a foreign tax law or non-tax reason, a payment would not qualify for the services cost method exception.³⁸ The proposed regulations provided taxpayers with a favourable answer here, saying that deductions for payments made to foreign related parties that qualify for the services cost method under US transfer pricing rules are not treated as base erosion payments.³⁹

In general, for a payment or accrual to be treated as a base erosion payment, the recipient must be a related foreign person, and a deduction must be allowable with

Notes

³² *Ibid.*

³³ US: Prop. Reg. § 1.59A-2(d).

³⁴ US: Prop. Reg. § 1.59A-7.

³⁵ US Code s. 59A(d) defines a base erosion payment. US Code s. 59A(c)(4) defines a base erosion percentage.

³⁶ US Code ss 59A(d)(1), (d)(2).

³⁷ US Code s. 59A(d)(5).

³⁸ US: Prop. Reg. § 1.59A-3(b)(3)(i).

³⁹ US: Prop. Reg. § 1.59A-3(b)(3).

respect to the payment or accrual. Section 59A(f). Treasury adopted a similar approach to excluding within the scope of this definition amounts that are treated as effectively connected income by the foreign recipient, and include an exception from the definition of base erosion payment for amounts that are subject to tax as income effectively connected with the conduct of a US trade or business, as well as payments taken into account in determining net taxable income under the treaty, as it did in connection with defining the gross receipts test.⁴⁰

One big problem built into the BEAT's mechanics and calculation, not addressed by the proposed regulations, is the possibility (indeed likelihood) of double taxation when both the GILTI regime and BEAT regime apply simultaneously. Unlike the German royalty deduction barrier, the BEAT provides no exception from the base eroding payments definition for payments that are includible into US taxable income as a result of the application of GILTI at the shareholder level. In addition, foreign tax credits don't help taxpayers in determining the amount of their BEAT minimum tax liability; in fact, they generally operate to cause taxpayers to be subject to a greater BEAT minimum tax. As a result, the possibility of double taxation of US shareholders' foreign income resulting from outbound payments made by members of a US consolidated group is persistent.

As this brief summary of just a few of the interpretive issues that have arisen over the newly enacted BEAT has demonstrated, the comprehensive BEAT regime – which attempts to include within its scope almost all outbound payments of a US persons to foreign related parties – is likely not one that should be copied by other countries. But while the German royalty deductive barrier may be a simpler model to follow, its lack of breadth may mean that it fails a comprehensive anti-base erosion test and leaves too many loopholes if the OECD preference is for adoption of a worldwide minimum tax. In addition, because the German rule requires that taxpayers perform a calculation and analysis of the tax treatment of the payment overseas, it is in some respects more complicated than the BEAT regime, which like the GILTI regime, is supposed to render such types of analyses irrelevant and unnecessary. But while the BEAT tried to make these

types of analyses irrelevant, in doing so it introduced a separate regime of extraordinary complexity and also significantly increased the possibility of double taxation. The mirror of a stripped down and simplified GILTI on the outbound payment side would appear to be something in between the US BEAT and the German royalty deduction barrier – more comprehensive than a rule that requires examination of the recipient's tax regime, but less comprehensive than a rule like BEAT that's overly broad in scope.

As noted by Johann Becker and Joachim Englisch of Munster University, adoption of an outbound minimum tax – a tax that limits the deductibility of outbound payments to foreign related persons in conjunction – enacted in conjunction with a comprehensive CFC/minimum tax regime should be well coordinated with priority rules to avoid 'double minimum taxation'. Becker and Englisch raise the possibility that allocation of responsibilities among countries as outlined in the hybrid mismatch report in BEPS Action 2 could serve as a blueprint for how to avoid or minimize the likelihood of double taxation.⁴¹ But adoption of such a priority rule on a broad and comprehensive scale – as would be needed if countries worldwide adopted minimum tax regimes – would seem to require more coordination among countries' tax regimes than currently appears possible.

3 CONCLUSION

Adaptation of the US international tax rules enacted in the TCJA to apply a minimum tax broadly and globally will require (i) simplification and modification of the GILTI rules; (ii) a narrowing of the BEAT rules; (iii) a means of coordinating between the two. In addition, work would need to be done to ensure compatibility of any such regime with the EU freedoms. Much technical work remains to be done before GILTI and BEAT can be translated into a GLOBE tax applicable worldwide, and if the types of interpretive and complex calculations currently being wrestled with by US taxpayers are to be minimized worldwide.

Notes

⁴⁰ US: Prop. Reg. § 1.59A-3(b)(3)(iii).

⁴¹ Tax Justice Network, *The German proposal for an effective minimum tax on multinational's profits* (15 Jan. 2019), <https://www.taxjustice.net/2019/01/15/the-german-proposal-for-an-effective-minimum-tax-on-multinationals-profits/> (accessed 31 Jan. 2019).