UNITED STATES

Ways and Means International Proposals Offer Up Surprises

by Andrew Velarde

Tax provisions from House Ways and Means Democrats that would substantially modify the international tax system are catching experts by surprise, including rules on the global intangible low-taxed income and foreign-derived intangible income provisions.

The massive 881-page tax text and the section-by-section summary, which were released September 13, address the international provisions as well as many changes to the tax code.

"If this were to go forward, it would once again be another significant change to the international tax regime," Joseph Calianno of Andersen Tax LLC said, adding that some proposals appear somewhat "more moderate" when compared with other plans put forth recently.

Kevin M. Jacobs of Alvarez & Marsal Taxand LLC seemed to agree. "If you compare this proposed legislation to either the green book or the Senate Finance Committee proposals, you can see many places where it's less harsh," he said. "That said, there's still a lot of that complexity that's associated with these proposals."

John L. Harrington of Dentons also argued that the Ways and Means draft generally follows the policy set by the Biden administration in its green book but doesn't always go as far as the administration. "While the corporate tax rate and GILTI changes were anticipated, with the new proposed rates being one of the few items of suspense, there are a lot of provisions in the draft that had not been previewed," he said.

A Comparatively Softer GILTI

According to the proposal, the GILTI rate would be raised to 16.5625 percent through a reduction to the section 250 deduction and an increase in the corporate rate. It also proposes moving GILTI to a country-by-country application based on controlled foreign corporation taxable units.

Notably, the Ways and Means proposal amends GILTI to allow for carryover of net tested losses. It also substantially reduces the foreign tax credit haircut on GILTI from 20 percent to 5 percent (0 percent for U.S. territories). In modifying the determination of deemed paid credits, a corporation is treated as a CFC only if it has direct U.S. shareholders.

Harrington welcomed the move to reduce the haircut, especially given the new restrictions on creditability, but he said allowing a 100 percent FTC would have been more welcome.

The Senate Finance Committee also proposed significant changes to GILTI in its draft bill, released August 25, including a move to CbC application of the provision. But unlike the House proposal, it leaves the rate unanswered beyond saying it will be increased through a reduction in the section 250 deduction. The Senate proposal is also undecided on the FTC haircut, asserting that it could range anywhere from zero to the current 20 percent, and it does not address the fate of losses beyond acknowledging them broadly.

Practitioners and taxpayers have decried the FTC haircut, which reduces FTCs under GILTI to 80 percent, as one factor that can raise the GILTI rate considerably higher than the 10.5 percent that it is sometimes said to cost. They have also voiced concern over the lack of guidance on the fate of losses under proposed GILTI modifications, including after the release of the green book.

While seeking to reduce the allowable net deemed tangible income return (the qualified business asset investment) for GILTI from 10 percent to 5 percent, the House version also does not go as far as the Senate version, which would remove the exemption altogether. The House reduction also would not apply to CFC taxable units in U.S. territories.

"The policy decision to treat the U.S. territories more favorably than foreign countries makes the proposals a little more complex, but it makes sense, given the draft's focus on incentivizing investment and activity in the United States," Harrington said.

The FACT Coalition criticized the Ways and Means plan for including "unnecessary additional foreign profit advantages" under GILTI because it did not require allocation of U.S. shareholder deductions for interest, research and development, and overhead. It also faulted the plan for allowing GILTI deductions to be carried into net operating losses.

"There is no reason to increase the already inappropriately high incentive to offshore investment and profits through these taxpayer friendly provisions," a September 13 FACT Coalition release states.

The FACT Coalition asserted that the Ways and Means plan increases the gap between foreign and domestic tax rates to just over 9 percent, whereas now it is just below 8 percent. It argued that Ways and Means should change the GILTI rate to at least 21 percent, maintain the 20 percent FTC haircut, and eliminate the QBAI exemption. The coalition made a similar call in September 2 comments on the Senate's proposal.

Decoupling of FDII and R&D

Speaking generally, Jacobs said it isn't entirely fair to draw comparisons between the Senate Finance Committee proposal and the Ways and Means proposal, since the former was incomplete.

"Ultimately, they are all trying to figure out which levers can you pull to generate revenue — so how do you determine that we don't like this, or we are willing to forgo this, or this added complexity generates this other benefit — when you don't know what is on the other side," Jacobs said.

The Ways and Means proposal would maintain the FDII provision, albeit at a reduced 20.7 percent rate for the deduction. This stands in contrast with the Senate proposal, which would change how the deduction is calculated, and the green book, which would eliminate it altogether.

"The fact that they are keeping it in the code . . . is significant," Calianno said.

Jacobs also pointed to the maintenance of FDII and the separate postponement of the amortization of research and experimental expenditures for the seeming decoupling of FDII from R&D incentives. This contrasts with earlier Democratic proposals that tied the two together.

FTC Modifications

The Ways and Means proposal would also modify the FTC rules, including the limitation provisions. It amends section 904 so that FTCs are determined CbC for purposes of sections 904, 907, and 960. Items are assigned to taxable units of a taxpayer, which include the taxpayer or CFCs, their interests held in a passthrough entity that are a resident of a different country, and branches that give rise to a taxable presence.

The bill would also repeal the foreign branch income basket. The carryforward period for an excess FTC limitation would be reduced from 10 years to five, and carrybacks would be repealed. In determining the GILTI basket FTC limitation, foreign-source income would only be allocated directly allocable deductions.

Harrington asserted that some FTC changes found in the bill were expected, especially how section 960 interacts with GILTI and limitations on FTCs by dual-capacity taxpayers. He noted that the draft followed the green book's lead but also implemented some broader policy changes that had not yet been previewed, such as the elimination of carrybacks and curtailing of carryforwards. Like the Senate draft, the implementation of the per-country limitation is not limited to GILTI but applies to FTCs as well, Harrington said.

"The per-country limitation adopted by the draft appears to be conceptually more in keeping with the description in the green book rather than the approach taken in the Senate discussion draft," Harrington said. "To its credit, the draft would repeal the foreign branch income basket, which seems superfluous if one adopts a per-country limitation."

Tracking History

The Ways and Means proposal would also amend section 245A, regarding the dividends received deduction, so that the 100 percent exemption only applies to dividends received from CFCs rather than a specified 10-percent-owned foreign corporation.

"The limitation of section 245A to CFCs was a surprise, especially for those corporate shareholders who were United States shareholders in foreign corporations that managed to avoid being a CFC or a [passive foreign investment company]," Harrington said. "That change probably leaves section 911 as the last vestige of 'territoriality' in our international tax rules."

What stuck out to Jacobs was the inclusion of changes to section 1059.

Under section 1059, if a corporation receives an extraordinary dividend on stock not held for more than two years before the dividend announcement date, its stock basis is reduced by the nontaxed portion of the dividend with excess treated as gain on a sale of stock. Under the proposal, a disqualified CFC dividend is extraordinary regardless of the holding period. A disqualified CFC dividend is one paid by a CFC to a U.S. shareholder if the dividend is attributable to earnings and profits earned or gain accrued when the foreign corporation was not a CFC, or the stock was not owned by the U.S. shareholder.

"If I buy from someone who was foreign, I need to trace all the earnings and profits of that stock. . . . You have to really track the history of shares," Jacobs said. "[That] becomes really interesting when you talk about the current stock market. When you are selling shares, you don't even know who you're buying from. So how do I know if the stock was owned or not owned by a U.S. shareholder?"

Jacobs added that if shares were purchased from the company rather than a 100 percent owner of a CFC, the rule would apply. "From an economics standpoint, what's the difference?" he asked.

Frankenstein's Monster

Substantial changes are also proposed for the base erosion and antiabuse tax. The Ways and Means proposal would raise the BEAT rate first to 10 percent after 2021, then to 12.5 percent after 2023, and finally to 15 percent after 2025. The BEAT would also be determined after accounting for tax credits. According to the summary, base erosion payments would also be changed to include amounts paid to related foreign parties that are capitalized under section 263A and amounts paid for inventory that exceed the cost of property to the foreign related party.

According to Harrington, the BEAT change would do away with the exemption for cost of goods sold. In calling for its elimination, the administration has criticized the BEAT as underinclusive because it does not cover COGS payments, such as inventory purchases or capitalization of royalties.

Though not identical, the Ways and Means approach seems to more closely align with the Senate's than the administration's. One of the more significant differences between Biden's international tax reforms and the Senate's proposal is the fate of the BEAT, which the Senate preserves. Biden would instead replace it with his stopping harmful inversions and ending low-tax developments (SHIELD) proposal.

Like the BEAT, the SHIELD plan would generally apply to payments that pose a risk to the U.S. tax base. However, SHIELD would do away with the BEAT and its trigger mechanism — which generally applies when cross-border related-party payments exceed 3 percent of total deductions — in favor of an effective tax rate threshold, potentially initially set at the GILTI rate. SHIELD would also differ from the BEAT by denying the deductions for the relevant payments instead of imposing a minimum tax on some adjusted measure of taxable income.

While the Senate tersely states that it envisions incorporating SHIELD into the BEAT, the House proposal offers more details that would seem to be at least thematically tied to SHIELD. It would provide an exception if taxpayers can show that payments were subject to an effective rate of at least the BEAT rate.

Calianno argued that the Ways and Means proposal is redefining the BEAT "to some degree" and that it appears to be incorporating some SHIELD concepts into the BEAT.

Jacobs pointed out the differences in how the BEAT and SHIELD operate, arguing that they are "totally different."

"It doesn't feel like the two policy plans should go hand in hand, but rather you should pick one and try to address it," Jacobs said. "They're taking the BEAT proposal and taking the SHIELD proposals and melding the two. It becomes jagged and requires further refinement, and taxpayers are really going to have to spend a lot of time analyzing how this new BEAT, if enacted, would apply." ■