AMERICANS for TAX REFORM

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Re: REG-104390-18 - ATR Urges Broader High-tax Exception to Section 951A Global Intangible Low Tax Income

November 21, 2018

The Honorable Steven Mnuchin
Secretary
U.S. Treasury Department
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Secretary Mnuchin:

I write concerning the Treasury department's proposed guidance regarding Internal Revenue Code Section 951A Global Intangible Low-Tax Income (GILTI) following passage of the Tax Cuts and Jobs Act (P.L. 115-97) ("TCJA").

I urge Treasury to release guidance enabling taxpayers to apply the statutory high-tax exception in GILTI to high-tax income that would otherwise be subpart F income but for an exception to Subpart F such as the active finance exception or active insurance exception.

Since high-tax passive income is excepted from current inclusion under Subpart F and GILTI pursuant to section 954(b)(4), it makes no policy sense, and is inconsistent with Congressional intent, for high-tax active income to be subject to current inclusion under GILTI.

The TCJA dramatically overhauled the U.S. international tax system. In the process of passing this reform, the law could be interpreted as having included high-tax, foreign source income in the new GILTI regime.

ATR believes this is poor policy that is not required by the statute and should be fixed – high-tax foreign income has historically been exempted from U.S. taxation under the Subpart F rules because it was already taxed in the country of origin.

Further, as the name "GITLI" makes clear, the provision was designed to apply to low-tax income, a fact also supported by the relevant legislative history.

In fact, failing to address this problem could create a situation where high-tax, foreign active business income is treated worse than easily-shifted passive income, creating perverse incentives for businesses to engage in needless restructurings, and resulting in a tax increase relative to pre-TCJA levels.

<u>Background</u>

Prior to TCJA, CFC (controlled foreign corporation) income fell into two categories – Subpart F income subject to immediate U.S. taxation and all other income subject to the deferral system.

Subpart F was designed as a base erosion provision to prevent a business from improperly shifting passive income (rents, royalties etc.) to low tax jurisdictions. Under the provision, any income designated as Subpart F income would be subject to full U.S. corporate tax when earned.

Exceptions were applied to certain types of income such as the "active financing exception," which exempted income earned in foreign markets as banking or financing income, and "active rents and royalties exception," which exempted income earned in the active conduct of a trade or business with an unrelated person.

Subpart F also included a high-tax exception under Section 954(b)(4) which exempted income if a taxpayer was able to prove that the income was subject to a foreign tax rate of greater than 90 percent of the U.S. corporate rate.

While TCJA left the Subpart F rules largely untouched, it added the GILTI provision which, like Subpart F income, subjects certain types of foreign income to U.S. corporate taxation.

In general, GILTI applies to income of a U.S. entity's Controlled Foreign Corporation (CFC) exceeding 10 percent of the deemed rate of return of that CFCs tangible assets.

However, GILTI is distinguishable from Subpart F in that it is structured as a worldwide tax imposed at a reduced rate and with exceptions for certain categories of income, including income eligible for the high-tax exception of Subpart F. While it was designed to impose taxation on low-tax IP-derived income of foreign subsidiaries, it is not necessarily limited to passive income and could apply to active business income.

This has resulted in an interpretive issue: to what extent can taxpayers earning high-tax income be able to utilize the statutory high-tax exception of Subpart F, which is cross-referenced by the GILTI statute, even though the income is also excepted from Subpart F because it is active business income?

This issue arises because GILTI sweeps up certain types of income that have not and were never intended to be subject to full U.S. taxation when earned.

<u>An Expansive High-tax Exception for GILTI is Needed to Protect Against Double Taxation</u>

While the policy underlying GILTI deserves thorough, long-term examination, Treasury should immediately interpret the statutory high-tax exception to ensure that GILTI serves its intended purpose of preventing base erosion, i.e., shifting of income to low-tax jurisdictions.

Under existing law, taxpayers face a system where high-tax passive CFC income is generally exempted from full U.S. taxation under Subpart F and GILTI.

At the same time, the GILTI regime could be interpreted as failing to exempt non-Subpart F income that has been taxed previously in a high-tax foreign jurisdiction and that would be Subpart F income but for some other exception such as the active finance exception under section 954(h).

This is problematic as the rationale for base erosion provisions is to counteract the possible shifting of intangible income to low tax jurisdictions.

However, there is no base erosion occurring when income is earned (and taxed) in a high-tax jurisdiction.

Because of the interactions between GILTI and Subpart F, high-tax active CFC income from foreign jurisdictions is now being treated worse than easily-shifted passive income. This makes no sense from a policy perspective.

This discrepancy could create significant adverse consequences for businesses and result in a net tax increase relative to pre-TCJA law. Businesses will now have perverse incentives to restructure business operations in a way that is costly, that creates future complexity, or that may not be practical in foreign jurisdictions.

This absence of a broadened exception will also harm American competitiveness given U.S. businesses face additional tax on high-tax CFC income, while foreign competitors face no additional tax on their high-tax income.

This problem can be addressed by interpreting the current high-tax exception in GILTI so that it applies not only to passive Subpart F income, but also to active high-tax non-Subpart F income.

Doing so is consistent with the statute and Congressional intent (as explained below), and would protect legitimate business operations and the precedent set by U.S. international tax law.

In addition, this provision is already vetted and would not create a windfall for taxpayers as the existing Subpart F provision is elective and only applies to the extent "the taxpayer establishes to the satisfaction of the Secretary" that the income has already faced high tax rates.

<u>An Expansive High-tax Exception is Consistent with Congressional Intent</u>

Not only is there a clear policy rationale for an expanded high-tax exception, there is clear legislative intent: Congress never intended to tax this type of income and supported a high-tax exception to GILTI.

While lawmakers understood the need for anti-base erosion provisions, they were principally concerned about intangible income being allocated to low-tax jurisdictions. As pointed out by the Senate Finance Committee, intangible income located in a high-tax jurisdiction had limited base erosion concern:

> "The Committee believes the type of income that is most readily allocated to low-or zero-tax jurisdictions is income derived from intangible property, or intangible income… At the same time, if intangible income is located in a jurisdiction with a sufficiently high tax rate, the Committee believes there is limited base erosion concern."

The Senate Finance Committee also points out that Congress intended for high-tax foreign income to be exempt from GILTI because this type of income is already exempted from U.S. tax:

> "The Committee believes that certain items of income earned by CFCs should be excluded from the GILTI, either because they should be exempt from U.S. tax – as they are generally not the type of income that is the source of base erosion concerns – or are already taxed currently by the United States. Items of income excluded from GILTI because they are exempt from U.S. tax under the bill include foreign oil and gas extraction income (which is generally immobile) and income subject to high levels of foreign tax."

Notwithstanding the interactions between GILTI and Subpart F in the final bill, lawmakers clearly intended to preserve the exception of CFC high-tax income when crafting the law as demonstrated above.

Conclusion

The interaction between the GILTI and Subpart F provisions following passage of TCJA has inadvertently created a situation where high-tax active CFC income may be treated worse than passive income.

This should be resolved by interpreting the high-tax exception in the GILTI regime to encompass high-tax active income. This exception would safeguard American competitiveness, clamp down on potential perverse business incentives to restructure, and protect against double taxation.

Thank you for your consideration. If you have any questions, please do not hesitate to contact me or ATR's Director of Tax Policy at ahendrie@atr.org or at 202-785-0266.

Onward,

Grover G. Norquist
President, Americans for Tax Reform