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In this article, the author contends that the sponsors of the Tax Cuts and Jobs Act not only failed to deliver on their promise of a territorial system for controlled foreign corporations, but also expanded the preexisting quasi-worldwide system.

The U.S. Congress and the White House claim that, after years of lobbying by U.S. multinational corporations, the Tax Cuts and Jobs Act (P.L. 115-97) has finally brought territoriality to the U.S. tax system. However, the revised Internal Revenue Code contains a rule for what it calls global intangible low-taxed income (GILTI)[1] that puts that claim into question.

Instead of creating a territorial system, the GILTI rule seems to create a harsher form of the opposite — quasi-worldwide taxation — than the U.S. had before. The new system will lead to results that may fluctuate widely depending upon the facts. It could fairly be called a variable worldwide system, but certainly not a territorial system.

Background

Since the enactment of subpart F in the U.S. in 1962,[2] the U.S. and most countries have adopted a two-sphere system for taxing domestic multinationals on income from foreign subsidiaries (that is, controlled foreign corporations).

One sphere involves passive income (for example, subpart F income); most countries require this income be attributed to the domestic parent in the year earned — whether or not distributed.[3]

The other sphere involves income earned by foreign subsidiaries from the active conduct of business. Here, we see three distinct approaches adopted by various countries. Before 2009, three key countries — the U.S., the U.K., and Japan — operated what could be termed quasi-worldwide or quasi-territorial systems. They did not tax undistributed active business profits of foreign subsidiaries (referred to in U.S. circles as deferral), but they did tax distributions thereof with a credit for foreign taxes paid or owing.[4]

In 2009 the U.K. and Japan changed their laws and joined what can be called the pure territorial camp — countries that do not tax either undistributed or distributed active business profits of foreign subsidiaries.[5] This camp includes most EU countries. It also includes Canada when Canada maintains a double taxation agreement or tax information exchange agreement with the country or countries in which the foreign subsidiary is based or operates.

Among the few, if not the only, countries known to have previously adopted a true, pure

[1] IRC section 951A.

[2] IRC section 951 et seq.

[3] Canada's counterparts are the controlled foreign affiliate and foreign accrual property income rules in sections 90-95 of the Income Tax Act, Canada.

[4] *See, e.g.*, former IRC section 902.

[5] For a discussion of the Japanese conversion, see Mindy Herzfeld and Mitsuhiro Honda, "Moving to Territorial: Lessons From Japan," *Tax Notes Int'l*, Jan. 8, 2018, p. 119. For a discussion of the U.K. conversion, see Amanda Athanasiou, "U.S. Could Learn From U.K. Tax Reform, IMF Says," *Tax Notes Int'l*, Jan. 22, 2018, p. 324.

worldwide system — that is, a system that taxes, in the hands of the domestic parent, the active business profits of a foreign subsidiary as soon as they are earned — are New Zealand and Finland.[6]

To summarize, by the beginning of 2017 most countries had a pure territorial system, but the U.S., before the TCJA, retained a mixed system that could be described as quasi-territorial or quasi-worldwide.

The TCJA and the U.S.

Against that background, U.S. multinationals lobbied hard for an end to the quasi-worldwide system and the adoption of a pure territorial approach. Both Congress and the Trump administration promoted the TCJA as effectuating the latter goal. However, as I will lay out, that is not what truly happened. Instead, the U.S. exchanged one form of quasi-worldwide taxation for what, in many cases, is a harsher form, and GILTI is the culprit. Surprisingly, this has not received much notice,[7] and the purpose of this commentary is to give it the attention it merits.

How does GILTI affect the playing field? It reduces or eliminates the benefits of the new territoriality approach or the participation exemption under new IRC section 245A.

GILTI refers to prescribed portions of the income of CFCs that are from active conduct of business (and therefore not included in attributable subpart F income) but that will nonetheless be attributable to the CFCs' U.S. shareholders because they are derived from specified types of active business situations and are, according to a definition discussed below, not subject to sufficient foreign taxes.

What types of business situations result in GILTI? From the words in the acronym itself, one would assume that the impugned business is the development or other procurement of intellectual property and the licensing or selling thereof. But that (logical) assumption would be wrong. Instead, GILTI is that portion of the income of any business (for example, selling widgets or running a hotel) that may be considered to arise from its intangibles (IP, goodwill, location, customer lists, know-how, and so forth), as opposed to income arising from the business's tangible property. Statutorily, that portion is identified and measured by a simple formula. GILTI is the amount of income exceeding 10 percent of the aggregate, adjusted basis of the depreciable tangible property of the business.

Suppose, for example, a U.S. person owns a hotel operation in the Bahamas through a Bahamian subsidiary. The net profit for the year is $1 million. The hotel owns land, buildings, furniture, fixtures, and equipment with an aggregate adjusted basis of $2 million. Therefore the intangible income for GILTI purposes is $800,000 ($1 million less 10 percent of $2 million).

That is a far cry from what one would assume from looking strictly at the wording of the term.

As for the low-tax element, it turns out that any foreign rate that is less than 90 percent of the new U.S. federal corporate rate of 21 percent is considered low-tax. Not only is a tax haven like the Bahamas covered, but the U.K. will be too once it proceeds with plans to lower its 19 percent corporate tax rate to 18 percent. At that time, our hypothetical hotel business would produce GILTI if located in either jurisdiction.

The GILTI formulas for corporate shareholders, including an inclusion rate of 50 percent (62.5 percent after 2025) and foreign tax credits, would seem to eliminate net GILTI-related inclusions when the effective rate paid by the CFC is 12.5 percent or higher during the first phase of these rules, becoming somewhat higher after 2025. Thus, there are harsher results for CFC shareholders who are individuals (and do not have a 50 percent reduction) than for corporate shareholders.

Notably, Canada does not have a counterpart to GILTI. If intangible-related income of a controlled foreign affiliate does not constitute foreign accrual property income, it is not attributed to the domestic shareholder regardless

[6] Both are discussed in "New Zealand's Territorial Tax System," NZ US Tax Specialists (Dec. 8, 2015).

[7] Lee Sheppard cryptically alluded to the situation when she wrote, "Congress repealed deferral without telling you. Deferral applies only to a narrow little slice of foreign income that is attributable to depreciable tangible assets." She preceded that comment with the boldfaced subheading, "Takeaway: There is so much clawback in the TCJA, hardly anything is left of the vaunted participation exemption." *See* Lee A. Sheppard, "International Clawbacks and Minimum Taxes in Tax Reform," *Tax Notes Int'l*, Jan. 1, 2018, p. 9.

of the level of foreign taxes incurred, including whether there is no foreign tax at all.[8]

Summary

Ultimately, the U.S. has gone from a system (quasi-worldwide) in which the full $1 million earned by the hypothetical hotel-operating CFC in the Bahamas would not have been taxed until repatriated — at which time all of it would have been taxed — to another type of quasi-worldwide system in which $800,000 of the $1 million in the Bahamian hypothetical would be immediately taxed but the other $200,000 would never be taxed owing to the new section 245A. Obviously, the hypothetical owner would prefer the old law.

Note that if we change the facts so that the Bahamian CFC nets only $200,000, the owner would prefer the new rules.

Hence my suggestion that we label the new regime a variable worldwide system. Calling it a territorial system is simply perpetuating an illusion. ■

[8] *See supra* note 3.