NATIONAL TAXPAYERS UNION

Issue Brief

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Treasury Can Keep GILTI from Harming Innocent Taxpayers

As a matter of policy, the Tax Cuts and Jobs Act (TCJA) elicited both support and opposition, largely along ideological lines. On that score, NTU and its allies generally applauded the bill's passage, despite some of its flaws. As a matter of law, however, questions arise over TCJA's implementation and interpretation that must transcend ideology. As my colleague Parker Gardner recently put it for the *Washington Examiner*, "Some issues ... are not and should not be partisan. Protecting taxpayers from unintended complexity and confusion should be one of them." This is the philosophy behind "technical corrections" legislation designed to ensure that tax laws reflect their original intent. Fortunately, some of these corrections need not drown in a raging sea of partisanship – they can be rescued through calm and thoughtful Treasury action.

Until the tax system is dramatically simplified, the reality is that technical corrections to the law will need to be adopted continuously and often. Indeed, the January 2, 2019 discussion draft of the "Tax Technical and Clerical Corrections Act" contained a modification to the Working Families Tax Relief Act that was enacted into law nearly 15 years ago. So it must be with a variety of TCJA provisions. In March of 2018 the Consolidated

Key Facts:

Provisions of TCJA have been implemented contrary to the legislative intent are subjecting American businesses to absurdly high tax rates, which are passed long to consumers, shareholders, and workers.

Ordinarily, this would be addressed in technical corrections legislation, but a technical corrections bill might not be able to pass (or pass quickly) in a divided Congress.

The Treasury Department can take the initiative and address the issue through its own regulation, and has historically done so to make policy align with legislative intent.

Appropriations Act provided a legislative fix to the so-called "grain glitch" in section 199A of TCJA that created favorable tax treatment for farmers that sold their goods to co-ops as opposed to private companies. TCJA's "retail glitch" that inadvertently condemns Qualified Improvement Property (mainly in the retail and restaurant sectors) to a yawning 39-year-plus depreciation schedule is another area of the new law ripe for clarification.

Yet few parts of the new law stand out more urgently for an expeditious repair than the complex interaction of TCJA's Global Intangible Low-Taxed Income (GILTI) provisions and its new Base Erosion Anti-Abuse Tax (BEAT) with American companies' income, resulting in a double-counting penalty and a tax rate far above what was intended by lawmakers. Although the matter defies easy explanation – a fact which by itself argues for a remedy – in the most simplistic sense TCJA's drafting errors have created a "no man's land" where American businesses that operate worldwide face withering tax consequences for perfectly legitimate transactions and operating practices.

One of TCJA's most important aims was to facilitate transition to a corporate tax system embodying more of the "territorial" virtues embraced by our trading partners: an American firm's profits earned in another country would generally be subject to that country's taxes, while those earned within U.S. borders would generally by subject to U.S. tax, levied at a new lower statutory federal rate of 21 percent. Both the territoriality and the low rate were designed to enhance the competitiveness of our federal tax system. GILTI was designed to trap and tax the income of U.S. shareholders in Controlled Foreign Corporations not otherwise hit by the conventional 21 percent tax, while BEAT is aimed at preventing earnings stripping through payment flows between related foreign and domestic entities.

In neither case were these parts of the law structured to create combined tax rates above 21 percent; in fact, GILTI's intended rate is 13.125 percent after several abstruse calculations are performed. That rate is supposed to serve as "floor" for income that a company might attempt to shift to a zero or single-percent jurisdiction. Yet because of the way GILTI rules were written in regard to expense allocations and apportionments, many firms and their shareholders find themselves in a costly limbo -- foreign tax credits cannot be used to full offset liabilities in higher-tax jurisdictions. The result could be a situation where American businesses pay a high tax rate on part of their income amounting to 25 percent, 30 percent, or more, while still being subject to a 13.125 percent American GILTI rate on that portion as well.

No one should be under the illusion that that this double tax is a minor nuisance affecting a handful of corporate titans. It is a burden that affects basic business decisions that were supposed to be less driven by tax consequences. It is a burden that millions of shareholders, including middle class retirees and state and local pension fund managers must bear. Consumers and workers suffer too: even the Congressional Budget Office acknowledges that labor bears a significant percentage of the corporate income tax, while some researchers peg the share at nearly 75 percent.

This form of punitive taxation, which occurs in a different context when BEAT enters the picture, is plainly contrary to Congressional intent and sound tax policy. TCJA's Conference Report stated how GILTI was supposed to operate, noting that: "At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate."

Ideally, Congress would address this problem in a straightforward manner by restoring the historic principle of preventing double taxation through sensible applicability of foreign tax credits in expense allocation and apportionment as well as base erosion tax amounts. Unfortunately, this legislative avenue may be inaccessible for quite some time. A more immediate solution presents itself: through Treasury

regulation, make the so-called Subpart F high-tax exception applicable in cases where GILTI income has already been taxed at relatively high foreign rates. One suggested threshold that seems reasonable is to exempt income taxed by a foreign entity from GILTI in those cases where the foreign rate is at least 90 percent of the conventional U.S. corporate tax rate (for a maximum of 18.9 percent). Few could argue that this ratio somehow confers an advantage for companies, as the most logical answer should be closer to the rate of 13.125 percent.

While the current issue involves conflicts with the intent behind TCJA's international provisions, the Tax Code has long recognized the principle of avoiding or mitigating double-taxation of U.S. companies that do business abroad – and Treasury has played a key role in developing this recognition. For example, U.S. law has provided relief for certain "dual capacity" taxpayers who footed the bill for foreign income taxes in the countries in which they operated while facing U.S. taxes here. In 1983 a Treasury rule was finalized that allowed companies in this position (many but not all of them in oil and gas) to take a credit against foreign tax liability. Because of controversies before that time – such as how to define a foreign "income" tax (as opposed to a royalty) or whether an expense deduction was more justified than a credit – the rule established strict definitions and qualifications for the credit. Although politicians in both parties have attempted to curtail or eliminate this credit, it endured those attacks. Treasury has thus established itself as a legitimate, authoritative voice in this area of tax policy.

The issue at stake today with TCJA is actually clearer than the one that prompted policymakers to recognize the credit for dual capacity taxpayers, and for Treasury to later refine it. The GILTI and BEAT provisions were intended to function as a minimum tax system, not a double tax scheme. It is not only unjustified, it is uncompetitive in the sense that it undermines the low-rate semi-territorial system envisioned under TCJA. It is also unproductive, in the sense that it contravenes a structure designed to incentivize repatriation of future foreign earnings that could be brought back to the U.S. under a reasonable interpretation of GILTI and BEAT.

It is certainly the case that other technical corrections should be made to ensure TCJA's economic growth benefits continue to unfold as they should. For example, small businesses are being deterred from making needed investments because of an obvious error in Qualified Improvement Property depreciation. Still, it is especially critical for Treasury to take the initiative on this GILTI reconciliation issue, because it is one of a few outstanding matters that could threaten the structural integrity of the entire international tax reform framework envisioned under TCJA. Some sixteen months after the passage of the tax reform law, major issues that could throw its proper functioning into flux must be addressed now. Past history demonstrates that it can be done. Future history demands that it should be done.

About the Author

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