Published on *The National Law Review* https://natlawreview.com

The Biden Administration Proposes Changes to the U.S. International Tax Rules

Article By:

David S Miller

Amanda H Nussbaum

Stuart L Rosow

Martin T Hamilton

Rita N. Halabi

Introduction and Summary

On March 28, 2022, the Biden Administration proposed changes to the U.S. international tax rules.

In short, the Biden Administration proposed to:

- Enact a 15% minimum "undertaxed profits rule" (a "UTPR") to replace the "Base Erosion Anti-Abuse Tax" ("BEAT"), and a 15% "qualified domestic minimum top-up tax" (a "QDMTT"). These proposals are intended to comply with "Pillar Two" – the "Global Anti-Base Erosion" ("GloBE") rules – of the "Inclusive Framework on Base Erosion and Profit Shifting" ("BEPS"), agreed to by the OECD/G20 member states on October 8, 2021.[1] Under the UTPR, U.S. corporations that are members of a foreign-parented multinational located in a jurisdiction that has not implemented an "income inclusion rule" (an "IIR") would be denied deductions as are necessary to ensure that the non-U.S. group pays an effective tax rate based on book (and not taxable) income of at least 15% in each non-U.S. jurisdiction in which the group has profits. An IIR imposes a "top-up tax" on an "ultimate parent entity" ("UPE") in its jurisdiction to produce a 15% minimum effective rate of book income in each taxing jurisdiction in which a member of the parent's group does business. GILTI and Subpart F are IIRs.[2]

The QDMTT proposed by the Biden Administration would be a 15% domestic minimum top-up tax that would grant the United States taxing priority over other countries enacting a UTPR. The Biden Administration proposal also indicates that U.S. multinationals will benefit from U.S. tax credits and other tax incentives, despite the fact that the OECD/G20 agreement would treat nonrefundable tax credits (like most U.S. tax credits) as reducing a company's effective rate of tax and would impose tax or deny deductions if those tax credits reduced the company's effective rate of tax below 15%.

- Increase the "Global Intangible Low-Taxed Income" ("GILTI") rate from 10.5% to 20% in conjunction with an increase in the corporate tax rate from 21% to 28% (which was proposed separately). Consistent with the Biden Administration's previous proposal, GILTI and Subpart F would be applied on a jurisdiction-by-jurisdiction basis to prevent blending. Applying GILTI and Subpart F on a jurisdiction-by-jurisdiction basis conforms them to the OECD/G20 agreement.

- Provide a 10% tax credit for expenses incurred in "onshoring a U.S. trade or business," which is reducing or eliminating a trade or business (or line of business) currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, but only to the extent that U.S. jobs result. The proposal would conversely deny deductions for "offshoring a U.S. trade or business," which is reducing or eliminating a trade or business or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs.

- Authorize the IRS to issue regulations to allow taxpayers to make retroactive "qualified electing fund" ("QEF") elections for their "passive foreign investment companies" ("PFICs") without requesting IRS consent, so long as the U.S. government would not be prejudiced.

Enact a UTPR and a QDMTT to Replace the BEAT

Background: The OECD/G20 agreement.

On October 8, 2021, the OECD and G20 countries agreed to subject multinational parent companies to an IIR and a UTPR.

The OECD/G20 UTPR acts as a backup to the IIR. It provides that if the parent of a multinational group is not subject to the IIR top-up tax, deductions will be denied to the other members of the group (or their taxes will otherwise be adjusted) to produce a 15% effective rate of tax in each taxing jurisdiction in which a member of the parent's group does business.

In December 2021, the OECD/G20 allowed countries to adopt a QDMTT. A QDMTT is a domestic minimum tax that is computed using the same rules as the OECD/G20's IIR and UTPR. If a country adopts a QDMTT, that country has first priority to claim top-up taxes for foreign subsidiaries whose effective rate is less than 15%. Effectively, adopting a QDMTT prevents other countries from denying deductions to group members.

Under the OECD/G20 rules, nonrefundable credits reduce a company's effective rate of tax and may subject the company to a UTPR. In the United States, most tax credits are nonrefundable, and, therefore, this rule was particularly controversial.

The OECD/G20 rules provide the following formula to calculate how the IIR top-up tax is divided among those countries that have adopted a UTPR:

50% x (number of employees in a country applying the UTPR/number of employees in all UTPR countries), plus 50% x (total net book value of tangible assets in a country applying the UTPR/total net book value of tangible assets in all UTPR countries).

The UTPR Proposed by the Biden Administration.

The Biden Administration would replace the BEAT with a UTPR that is consistent with the OECD/G20's UTPR. The UTPR proposed by the Biden Administration would apply to both domestic corporations that are part of the non-U.S. group and U.S. branches of non-U.S. corporations. Under the Biden Administration's UTPR, these entities would be disallowed U.S. tax deductions to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an effective tax rate of at least 15% in each foreign jurisdiction in which the group has profits.[3]

Profit and effective tax rate for a jurisdiction would be based on the group's consolidated financial statements, with certain adjustments, rather than taxable income. In addition, the computation of a group's profit for a jurisdiction would be reduced by an amount equal to 5% of the book value of tangible assets and payroll with respect to the jurisdiction.[4]

The proposed UTPR would apply to non-U.S. multinationals that have global annual revenue of $850 million or more in at least two of the prior four years. The UTPR would not apply to a group's profit in a jurisdiction if the three-year average of the group's revenue in the jurisdiction is less than $11.5 million and the three-year average of the group's profit in the jurisdiction is less than $1.15 million. Finally, the UTPR would not apply to a group with operations in no more than five jurisdictions outside of the group's primary jurisdiction and the book value of the group's tangible assets in those jurisdictions is less than $57 million. This exception would expire five years after the first day of the first year in which the UTPR otherwise would apply to the group.

The deduction disallowance would apply pro rata with respect to all otherwise allowable deductions, and it would apply after all other deduction disallowance provisions. To the extent that the UTPR disallowance for a taxable year exceeds the aggregate deductions otherwise allowable to the taxpayer for that year, the excess amount of the UTPR disallowance would be carried forward indefinitely until an equivalent amount of deductions are disallowed in future years.

A coordination rule would reduce the UTPR disallowance imposed by the United States to reflect any top-up tax collected by members of the group in accordance with the OECD/G20 UTPR (a "qualified UTPR") in one or more other jurisdictions. With respect to each financial reporting group, the percentage of top-up tax allocated to the United States would be determined by the following formula where a jurisdiction applies a qualified UTPR:

US allocation = 50% × Number of employees in the U.S./Number of employees in all OECD/G20 jurisdictions + 50% × Total book value of tangible assets in the U.S./Total book value of tangible assets in all OECD/G20 jurisdictions.

This formula matches the OECD/G20 version.

The QDMTT Proposed by the Biden Administration

To ensure that the U.S. has taxing priority over other countries that have enacted a UTPR, the Biden Administration has also proposed to enact a QDMTT. The QDMMT would equal the excess of (a)

15% of the financial reporting group's U.S. profit, using the same rules as under the UTPR to determine the group's profits for a jurisdiction, over (b) all the group's income tax paid or accrued with respect to U.S. profits (including state income taxes, corporate alternative minimum tax, and creditable foreign income taxes incurred with respect to U.S. profits).

The Biden Administration's proposal provides, without explanation, that U.S. taxpayers would benefit from tax credits and other incentives (apparently despite the fact that they are nonrefundable and would normally reduce the effective rate of tax under the OECD/G20 agreement).

The proposals to replace the BEAT with the UTPR and QDMTT would be effective for taxable years beginning after December 31, 2023.

Increase GILTI Rate to 20%

Under current law, the GILTI regime generally imposes a 10.5% minimum tax on 10% U.S. corporate shareholders of "controlled foreign corporations" ("CFCs"), based on the CFC's "active" income that exceeds a threshold of 10% of the CFC's tax basis in certain depreciable tangible property (this basis, "qualified business asset investment" or "QBAI"). At present, a U.S. shareholder's GILTI inclusion is calculated on an aggregate basis. Accordingly, U.S. multinational corporations blend income and losses from low-tax jurisdictions with income and losses from high-tax jurisdictions, potentially avoiding the GILTI tax on the earnings of subsidiaries in low-tax jurisdictions.

The Biden Administration has proposed to increase the GILTI rate from 10.5% to 20%, in conjunction with an increase in the corporate tax rate from 21% to 28%. Moreover, the Biden Administration has proposed to apply GILTI on a jurisdiction-by-jurisdiction basis to prevent blending.

Onshoring Tax Credit/Offshoring Loss of Deductions

To encourage U.S. employers to bring offshore jobs and investments back to the United States, the Biden Administration has proposed a new general business credit of 10% of the eligible expenses paid or incurred in onshoring a U.S. trade or business. Onshoring a U.S. trade or business is defined as (a) reducing or eliminating a business or line of business currently conducted outside the U.S. and (b) starting up, expanding or otherwise moving the same trade or business within the United States, to the extent that this would increase U.S. jobs.

To discourage U.S. employers from moving U.S. jobs offshore, the Biden Administration has proposed to (a) disallow deductions for expenses paid or incurred in connection of offshoring and (b) deny deductions for a U.S. shareholder's GILTI or Subpart F income inclusions for any expenses paid or incurred in connection with offshoring. Offshoring is defined as (a) reducing or eliminating a trade or business or line of business currently conducted in the United States and (b) starting up, expanding or otherwise moving the same trade or business outside the United States, to the extent that this would lead to a loss of jobs in the United States.

Expand Access to Retroactive QEF Elections

A PFIC is a foreign corporation with primarily passive income or passive assets, whose shareholders are not subject to the CFC rules. Under the PFIC rules, gain realized on the disposition of stock of a PFIC is treated as an "excess distribution," which is included in the shareholder's gross income as ordinary income and gives rise to an additional tax in the nature of a penalty based on the interest rate that applies to tax underpayments. PFIC shareholders that make a QEF election can avoid this additional tax on excess distributions and instead pay tax on their pro rata share of the PFIC's ordinary income and long-term capital gains.

Under current law, a PFIC shareholder is entitled to make a QEF election (or protective election) for a taxable year at any time on or before the due date such shareholder must file its tax return; however, to the extent permitted by regulations, a shareholder may make a late, or retroactive, QEF election if the shareholder reasonably believed that the company was not a PFIC. A PFIC shareholder that has failed to timely make a QEF election or protective QEF election can make a retroactive QEF election only if (a) the shareholder relied on a qualified tax professional's advice; (b) the U.S. government's interests are not be prejudiced by granting consent; and (c) the shareholder requests special consent before the issue is raised on audit.

The Biden Administration has proposed to eliminate the requirement that a shareholder must have relied on a qualified tax professional's advice and the requirement that a shareholder must have sought special consent. Instead, the IRS would be authorized to permit a taxpayer to make a retroactive QEF election without requesting consent, so long as the election would not prejudice the U.S. government. In addition, the IRS would be authorized to permit partnerships and other non-individual taxpayers that inadvertently fail to make a QEF election to do so retroactively.

ENDNOTES

[1] On October 8, 2021, the OECD/G20 member states agreed in principle to two "pillars" to reform international taxation rules. "Pillar One" would address digitalization and allow countries to tax very large multinational companies that do not have a physical presence in the taxing jurisdiction. The GloBE rules of "Pillar Two" contain mechanisms to identify pools of low-taxed income in multinational groups and imposes a minimum effective rate of tax of 15% in each jurisdiction in which the groups operate.

[2] However, the OECD/G20 agreement requires an IIR to be based on book income, and GILTI and Subpart F are based on taxable income.

[3] The Green Book provides the following example:

A group with $1,000x of profits in a foreign jurisdiction with no corporate income tax would have a top-up tax amount of $150x with respect to that jurisdiction. If the top-up tax were not collected under GILTI or an IIR implemented by a foreign jurisdiction, a U.S. corporation or U.S. branch that is a member of the group would be subject to a deduction disallowance of $536x, equal to the top-up tax amount of $150x divided by the U.S. corporate income tax rate of 28 percent. (For simplicity, this example assumes that there are no tangible assets or payroll in the foreign jurisdiction with no corporate income tax, and that there are no other jurisdictions with a UTPR such that all of the top-up tax is allocated to the U.S. corporation or U.S. branch.)

A financial reporting group is any group of business entities that prepares consolidated financial statements and that includes at least one domestic entity or domestic branch and at least one foreign entity or foreign branch. "Consolidated financial statements" means those determined in accordance with U.S. Generally Accepted Accounting Principles ("GAAP"), International Financial Reporting Standards ("IFRS") or other methods authorized by the IRS under regulations.

[4] The reduction corresponds to the "substance based income exclusion" in the OECD/G20 rules.

During a transition period of nine years, the exclusion would be 7.8% of the book value of tangible assets and 9.8% of payroll, declining annually by 0.2 percentage points for the first four years, by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.

National Law Review, Volume XII, Number 112