The Daily Dish

Getting the TCJA Right

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Eakinomics: Getting the TCJA Right

The Tax Cuts and Jobs Act (TCJA) did not just cut taxes. It also contains the most significant international tax reform since the inception of the corporation income tax, moving the United States away from a worldwide orientation to a system that exempts from tax certain dividends received from foreign affiliates (as is the case in nearly every other advanced economy). But a recently proposed regulation from the Trump Administration could undercut the success of this reform.

This international tax reform enhances U.S. growth and competitiveness. Under the prior worldwide system, when a U.S. firm competed with a German firm in the UK, both paid the UK tax. But unlike the German firm, the U.S. firm would then owe a second layer of tax up to the prior 35-percent U.S. corporate rate, putting it at a competitive disadvantage. The U.S. firm could "solve" this problem by not repatriating the earnings to the United States, but that just distorted capital structures and harmed the U.S. economy. Further, the prior rules encouraged takeover of U.S. companies by foreign competitors to escape the uncompetitive U.S. international tax regime.

The TCJA fixed this uncompetitive, anti-growth approach to business taxation – almost. As part of the modernization, TCJA explicitly considers the role of investment in intellectual property (IP). It taxes intangible income derived from serving foreign markets through U.S.-based operations (called Foreign-Derived Intangible Income, or FDII) at a 13.125 percent rate. And in order to ensure the new territorial approach does not cause companies to move valuable IP abroad to tax havens, the TCJA added the Global Intangible Low-Taxed Income (GILTI) provision that is intended to apply a minimum tax when a company's aggregate foreign tax rate on its intangible income is below the 13.125-percent FDII rate.

The tax on GILTI was intended to be fully offset by foreign tax credits when a company's aggregate foreign tax rate was 13.125 percent or higher. As stated in the conference report to the bill as voted on by members of Congress, "At foreign tax rates greater than or equal to 13.125%, 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."

The intent of Congress is clear, but the Treasury's proposed regulations to implement GILTI can cause U.S. companies with foreign tax rates exceeding 13.125 percent – or even rates above the top U.S. rate of 21 percent – to still owe U.S. tax on GILTI, even after the Treasury's proposed High-Tax Exception (HTE) from GILTI.

The root of the problem is the interaction between legacy "expense allocation" rules, which limit the foreign tax credits that companies can claim, and the GILTI regime. A veritable "who's who" of the business community recently wrote to Treasury Secretary Mnuchin and pointed out that "as a result of the expense allocation rules in the proposed foreign tax credit regulations:

- For taxpayers all of whose income is subject to a foreign tax rate of between 13.125 percent and 18.9 percent, the HTE is not available and, for these taxpayers, every $100 of domestic expense allocated to

GILTI increases U.S. tax on GILTI by $21.

- For taxpayers with pools of foreign income that are subject to foreign tax at rates that are both above and below 18.9 percent, expense allocation will cause GILTI to be owed where the average foreign tax rate after the HTE is 13.125 percent or more."

While the proposed HTE is welcome, the Treasury should honor the intent of Congress by also issuing regulations that cap expense allocation so that it does not cause companies to lose foreign tax credits that would otherwise offset U.S. tax on GILTI, when their foreign tax rates on GILTI exceed 13.125 percent.

There is more at stake than the special pleadings of global businesses for a reduced tax rate. The primary goal of the TCJA was to eliminate tax-based impediments to global competition in order to promote U.S. economic growth. GILTI too should be administered to generate U.S. competitiveness and growth.