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ALERT ▪ Tax

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Senate Democrats Release International Tax Discussion Draft Bill

Senate Finance Committee Democrats unveiled a "discussion" draft bill that would implement certain international tax proposals included in the Biden Administration's Made in America Tax Plan and generally follows the Senate framework for international tax reform proposed on April 5, 2021. Among other key proposals, the discussion draft revamps the U.S. subpart F rules and Global Intangible Low-Taxed Income regime (GILTI), which it renames Global *Inclusion* of Low-Tax Income, to ensure that income of a controlled foreign corporation (CFC) is taxed at a minimum rate on a country-by-country basis.

While the discussion draft does not address specific tax rates, it clearly contemplates a higher rate of current U.S. taxation on GILTI. In contrast with the Biden Administration and House proposals to date, the discussion draft creates exemptions on a county-by-country basis from current income tax for high-tax foreign income that otherwise would be subject to GILTI, subpart F, or direct U.S. taxation (with respect to income earned in a high-tax foreign branch). In addition to reforming GILTI and conforming the subpart F regime to more closely align with the reformed GILTI rules, the discussion draft proposes significant changes to the foreign tax credit rules and the Foreign-Derived Intangible Income deduction (FDII) regime to encourage domestic R&D. The discussion draft retains the Base Erosion and Anti-Abuse Tax (BEAT) and applies a higher rate of tax for payments to low-tax jurisdictions. While the discussion draft is broadly consistent with the objectives described in the Made in America Tax Plan, it leaves open critical policy determinations regarding rates and the availability of offsets, as noted below. The Senate Democrats envision this draft bill being included in the $3.5 trillion budget reconciliation bill.

The provisions of the discussion draft bill are summarized below.

Country-by-Country Global Inclusion of Low-Tax Income (GILTI)

- The draft bill eliminates the current 10% exemption from current GILTI calculations determined in respect of qualified business asset investment (QBAI).
  - By eliminating this exemption based on QBAI, the effective rate of tax on GILTI would be higher, particularly with respect to operations requiring physical capital investment.
  - The stated purpose of the elimination is to reduce tax incentives for making capital investments in low-tax jurisdictions.
- The draft bill effectively provides for GILTI to be calculated on a country-by-country basis, under which all operations of a CFC and its expanded group in the same country would be aggregated into a single "tested unit." Provided the tested unit is neither high-tax nor in a net loss position, the GILTI regime would impose incremental tax on the "net CFC tested income" of the tested unit (and tested units in other countries that meet the same criteria).
  - GILTI is currently taxed at 50% of the applicable tax rate based on a deduction under Internal Revenue Code (IRC) Section 250. The draft bill does not address whether the IRC Section 250 deduction will be reduced or eliminated.
  - Foreign tax credits will remain available to offset net CFC tested income under the GILTI regime, subject to a potential "haircut" of up to 20% as under current law (though the draft bill leaves open the possibility of eliminating the haircut).

- Income from tested units the effective tax rate of which is higher than the GILTI rate ("high-tax tested income") would generally not be included in net CFC tested income that would be subject to tax under the GILTI regime. The determination of the effective tax rate for purposes of the high-tax tested income exclusion would generally be based on the current GILTI high-tax exclusion regulations.

- If a tested unit has a "tested loss," the tested unit would be excluded from the calculation of net CFC tested income and thus the loss would not be available to offset income of a tested unit from another country. This effectively ensures that incremental tax will be imposed on income earned in each country that has a tested unit with net CFC tested income (because net losses from another country cannot offset such income).

- Under this system, high-tax income of a CFC owned by a U.S. corporation generally would not be subject to U.S. tax assuming that, when such income is repatriated to the United States, the income qualifies for the IRS Section 245A deduction for foreign-source dividends. In addition, the draft bill provides that foreign tax on such high-tax income would not be eligible for a foreign tax credit.

Subpart F

- The draft bill updates the high-tax income rules of the subpart F regime to track the corresponding changes to GILTI, including the adoption of similar foreign tax credit rules and applying the country-by-country high-tax exclusion system (each of which would be applied separately for passive and general foreign tax credit baskets). The high-tax exclusion rate for subpart F income would be the standard corporate tax rate, and the amount of a foreign tax credit haircut for subpart F inclusions is under consideration (and could be different from the amount for GILTI).

High-Tax Exclusion for Branch Income

- The draft bill creates a similar high-tax income exclusion for foreign branch income of a U.S. person based on the maximum applicable tax rate (*i.e.*, corporate or individual), and may apply a foreign tax credit haircut to such income.

Research and Experimentation Expenses and Stewardship Expenses

- The draft bill treats research and experimentation expenses and stewardship expenses attributable to activities performed in the United States as allocable only to U.S.-source income for foreign tax credit limitation purposes.

    - This change would prevent U.S. R&D activities from limiting the use of foreign tax credits (thereby removing incentives to perform R&D offshore).

Foreign-Derived Intangible Income (FDII)

- The draft bill would change "foreign-derived intangible income" to "foreign-derived innovation income," which would be calculated based on the "domestic innovation income" (DII) (computed under new rules) instead of a deemed intangible return based on QBAI.

    - In effect, DII would consist of a certain as of yet undetermined percentage of qualified research and development expenditures and qualified worker training expenses. The FDII deduction would continue to use the "foreign derived ratio" and multiply the ratio by DII to determine the deduction-eligible amount.

- Under the draft bill, the FDII deduction would be usable at the same percentage as the GILTI deduction under IRC Section 250 (currently the FDII percentage is lower than the GILTI percentage). As noted above, that percentage is not specified in the draft bill.

Base Erosion and Anti-Abuse Tax (BEAT)

- The drafters of the bill are still considering the best way to incorporate into the BEAT the purposes and policies of the Stopping Harmful Inversions and Ending Low-Tax Developments (SHIELD) proposal put forth by the Biden administration (as opposed to discarding the BEAT and replacing it with SHIELD).

- The BEAT currently applies a 10% minimum tax rate to “modified taxable income,” which includes base erosion income. The draft bill applies the 10% rate only to regular taxable income and would apply a higher, unspecified, minimum tax rate to base erosion income. The 10% rate is currently set to increase to 12.5% after 2025, and the higher rate would also increase.

- Consistent with the emphasis on preserving tax incentives for domestic activities, the draft bill gives full value to IRC Section 38 domestic business credits by excluding all such credits from reducing regular tax liability (currently, a portion of such credits may reduce regular tax liability, having the effect of increasing the BEAT minimum tax).