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COMMITTEE on FINANCE
U.S. SENATOR RON WYDEN (D-OREGON), RANKING MEMBER
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Trump's Tax Law and International Tax: More Complexity, Loopholes and Incentives to Ship Jobs Overseas

Report of the Senate Finance Committee Democratic Staff

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While Donald Trump and Congressional Republicans claimed the top priority of their tax law was promoting jobs and investment in the United States, their new international tax regime instead rewards companies for investing overseas.

Even before Republicans passed Trump's tax law in 2017, the United States' international tax rules were a complicated mess in desperate need of reform. A high statutory tax rate combined with deferral – the ability of U.S. multinationals to hold income overseas and avoid paying tax to the U.S. until that income was repatriated – created an incentive for U.S. corporations to shift jobs and capital offshore.[1] The growth of highly mobile income from intangible property (IP), like patents, made it easier for U.S. multinationals to shift income to tax havens while simultaneously stripping the U.S. tax base.

Bipartisan proposals to reform this broken system existed,[2] but, rather than working across the aisle, Trump and Congressional Republicans created even greater complexity, new gigantic loopholes, and a system that continues to encourage foreign over U.S. investment. The final product is another in the litany of broken promises of Trump's tax law.

MYTH: Trump's tax law makes the tax code simple, fair, and easy to understand[3]

Rather than creating a new, simpler system for taxing foreign income, Trump and Republicans chose to layer additional complexity on top of a broken system. The international tax laws governing the taxation of passive income like interest, known collectively as subpart F, contain some of the most complicated rules in the tax code.[4]

Trump's new system targeting highly mobile intangible income (Global Intangible Low Taxed Income, or "GILTI") largely retains the existing subpart F rules and adds new rules that both rely on the old system and create a new web of complexity. Taxpayers are left in the dark, waiting to make investment decisions, as it is now up to the Treasury Department to clarify a hastily written law.

The result, as one former tax practitioner states, is a "jumbled mess" that in some places "leaves gaping holes" and has "wreaked havoc [in] many ways."[5] The complexity has accountants calling Trump's tax law "The Full Employment Act."[6]

MYTH: Trump's tax law puts an end to the incentive to ship jobs overseas

Even the provisions intended to discourage investment outside the U.S. may have created the opposite effect. Trump's new system begins with the premise of a minimum tax rate on foreign earnings of half the U.S. tax rate.[7] However, in the name of targeting taxation of "low-taxed intangible income," the GILTI system exempts a "routine" rate of return on depreciable assets outside the U.S.[8]

That means a low-margin company pays no tax to the U.S. on income earned from offshore investments, such as new plants and equipment (and the jobs to build and run them). Far from ending the incentive to ship jobs overseas, this provision encourages manufacturers to locate new plants offshore.[9, 10]

MYTH: Trump's tax law closes corporate loopholes

The bad incentives don't end there. Despite claiming to tax intangible income in low-tax jurisdictions, Trump's tax law includes rules that allow multinational corporations to eliminate tax that would otherwise have been paid on intangible income stashed in tax havens.

The technique, called "cross-crediting," allows a company operating in a high-tax jurisdiction to lower or eliminate U.S. tax on income shifted to a low-tax jurisdiction. If a company has stashed IP in a tax haven with a tax rate well below the GILTI "minimum," it should pay tax to the U.S. under the GILTI system. But, if that company also has earnings in a country with an effective tax rate above the GILTI "minimum," the extra foreign tax credits arising from taxes paid to that foreign jurisdiction can be used to minimize or eliminate U.S. taxes owed on the income from the tax haven.

Democrats proposed an amendment that would have addressed this type of gaming during the Finance Committee mark-up of Trump's tax law. Not a single Republican supported the amendment.[11]

MYTH: Trump's tax law brings American companies back home and attracts new businesses to the U.S.

Republicans claim that Trump's tax law will be a boon to domestic investment, but the design of the law actually further encourages offshoring of plants and equipment.

The law dangles a special domestic tax rate (13.125 percent) for "foreign derived intangible income" (FDII), which is essentially income tied to exports. However, in a convoluted twist, new investment in plants and equipment in the U.S. actually reduces the FDII tax incentive. That means more investment in plants and equipment in the U.S. results in a smaller FDII deduction and higher U.S. tax.

Add this to multinational corporations' ability to reduce any potential GILTI tax liability by moving plants and equipment overseas, and Trump's tax law is a recipe for offshoring.

MYTH: Trump's tax law puts America on a level international playing field

Even stranger, the system touted as targeting low-taxed intangible income ends up punishing companies operating in high-tax jurisdictions that have no foreign intangible income.

A company that holds all their intellectual property in the U.S., conducts all their research and development in the U.S., and operates only in foreign countries with tax rates higher than the U.S. could still end up paying additional tax to the U.S. That's because expense allocation rules, credit haircuts, and the elimination of carryback and carryforward rules in Trump's tax law were not fully thought through and could end up harming companies that invest and hire in the U.S.[12]

Rather than leveling the international playing field, Trump's tax law punishes companies that have not gamed the system with aggressive tax planning and that operate in countries with tax rates higher than the U.S. Meanwhile, those shifting income to tax havens and offshoring U.S. jobs continue to be rewarded.[13, 14]

In the end, Trump and Congressional Republicans failed to pass a lasting bipartisan law that promotes jobs and investment in the United States. Through additional complexity, new loopholes, and backwards incentives, the law breaks Trump's promises. It's a shame that Trump's new system is one where U.S. companies are still better off investing offshore than in U.S. workers.

ENDNOTES

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[1] Provided companies could avoid certain rules subjecting that income to immediate taxation by the U.S., such as the anti-deferral provisions of subpart F. As explained by the Congressional Budget Office (CBO), although U.S. multinationals could not directly access these earnings, they often invested the funds in U.S. securities, including long-term Treasuries, and paid significant amounts to shareholders, "so it is unlikely that the foreign earnings represent pent-up dividends or investments waiting to happen."

Congressional Budget Office, "The Effects of the 2017 Tax Act on CBO's Economic and Budget Projects," The Budget and Economic Outlook: 2018 to 2028, at 109, April 9, 2018. See https://www.cbo.gov/publication/53651

See also Steve Shay, "The Truthiness of 'Lockout': A Review of What We Know," Tax Notes, March 16, 2015. See https://dash.harvard.edu/handle/1/14445470

[2] For example, S. 3018, the Bipartisan Tax Fairness and Simplification Act of 2010, 111th Congress, and S. 727, the Bipartisan Tax Fairness and Simplification Act of 2011, 112th Congress. See also "The International Tax Bipartisan Tax Working Group Report," Senate Committee on Finance, July 2015.

[3] "United Framework for Fixing Our Broken Tax Code," September 27, 2017. See https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf. The Trump Administration, the House Committee on Ways and Means Republicans, and the Senate Committee on Finance Republicans released a "framework" with policy goals and the promise of a transparent and inclusive committee process.

[4] While, under previous law, taxation of active business income of foreign CFCs could be deferred until it was repatriated as a dividend to U.S. shareholders, subpart F required current taxation of passive income, such as dividends, interest, rents, and royalties. See Internal Revenue Code (IRC) §951 et seq.

[5] Mindy Herzfeld, "Tax Cuts Chaos," Tax Notes, April 9, 2018. See https://www.taxnotes.com/tax-reform/news-analysis-tax-cuts-chaos. The poorly designed and hastily written ideas center around a new system that calculates taxation at the shareholder level but relies on rules written at the entity level. Foreign tax credit basketing, carryforwards, pooling, and expense allocation rules are all unclear or totally absent from the law.

[6] Roger Russell, "The Accountants Full Employment Act?" Accounting Today, December 19, 2017. See https://www.accountingtoday.com/news/the-accountants-full-employment-act

[7] Conference Report to Accompany H.R. 1, H.R. Report 115-466, at 626-627, December 15, 2017. See https://www.congress.gov/congressional-report/115th-congress/house-report/466/1

[8] 10% of adjusted depreciable basis is excluded from tested income, effectively removing earnings below this threshold from U.S. taxation.

[9] See Example 1 of the Appendix for more detail.

[10] "Early Impressions of the New Tax Law," Hearing before Senate Committee on Finance, 115th Congress, April 24, 2018. Statement of Rebecca M. Kysar, Professor of Law, Brooklyn Law School. See https://www.finance.senate.gov/hearings/early-impressions-of-the-new-tax-law

[11] Results of Executive Session to Consider an Original Bill Entitled Tax Cuts and Jobs Act, Senate Committee on Finance, November 14-16, 2017. See https://www.finance.senate.gov/hearings/continuation-of-the-open-executive-session-to-consider-an-original-bill-entitled-the-tax-cuts-and-jobs-act4

[12] Allocation rules will likely require U.S. interest, R&D expense, and general or administrative expenses to be allocated to the CFC (GILTI basket), which ultimately reduces the foreign tax credit limitation and increases U.S. tax on GILTI. The reduced rate provided through FDII is also reduced by the same expense allocation provisions. See Treas. Reg. §1.861-8 et. seq.

[13] Richard Rubin, "New Tax on Overseas Earnings Hits Unintended Targets," Wall Street Journal, March 26, 2018. See https://www.wsj.com/articles/new-tax-on-overseas-earnings-hits-unintended-targets-1522056600

[14] See Example 3 of the Appendix for more detail.

APPENDIX

The analysis of Republican myths in this report can be numerically supported through simplified examples of multinational corporations in common situations. The first example below presents a manufacturing company looking to invest in a new factory. The second example presents a global corporation with high-margin returns and significant foreign manufacturing. The third example presents a U.S. service company or manufacturing company that focuses investment in the U.S. and has foreign operations in relatively high-tax foreign jurisdictions like Mexico, Germany, and China.

Background: Calculating GILTI and FDII

Global Intangible Low Taxed Income (GILTI)

The new system for taxing foreign income of U.S. multinationals targets "global intangible low taxed income." The tax on GILTI is generally calculated by applying the full U.S. corporate tax rate (21 percent) on half of the final GILTI "inclusion."[15] In theory, this results in GILTI being taxed at half the U.S. rate.[16] The GILTI tax is assessed on certain U.S. shareholders of controlled foreign corporations (CFCs).[17]

To determine its GILTI inclusion, a taxpayer takes its aggregate share of each CFC's tested income (gross income of CFCs with certain items excluded), minus allocable deductions, including foreign taxes.[18] The taxpayer then deducts its net deemed tangible return – essentially 10 percent of the adjusted basis of any tangible assets of CFCs used to produce tested income.[19] The result is the taxpayer's GILTI inclusion.

While a U.S. taxpayer is allowed to take foreign tax credits (FTCs) against GILTI tax liability, the FTCs are subject to certain limits. First, FTCs with respect to GILTI tax liability are limited to 80 percent of foreign taxes paid on tested income, and then further limited by multiplying that amount by the "inclusion percentage" (the GILTI inclusion divided by net tested income).[20] Second, these FTCs are limited to a U.S. taxpayer's U.S. tax liability on foreign-source income, less allocable expenses (including allocated and apportioned domestic expenses).[21] This second limitation applies to both GILTI and other types of foreign income. After calculating these two amounts, the taxpayer is limited to claiming the lesser of the two.[22]

Since a U.S. taxpayer is allowed to claim FTCs against GILTI tax liability, the taxpayer must add those taxes back to income to avoid receiving the double-benefit of both a credit and deduction for foreign taxes. This add-back, known as the "section 78 gross-up," is equal to the inclusion percentage multiplied by foreign taxes paid on tested income.[23]

Once foreign taxes have been added back to the GILTI inclusion, the U.S. shareholder takes the GILTI deduction, which is 50 percent of this combined total.[24] The remaining GILTI is subject to the U.S. corporate tax rate of 21 percent, less any allowable FTCs.

Foreign Derived Intangible Income (FDII)

In addition to the GILTI deduction, domestic corporate taxpayers are allowed a 37.5 percent deduction for "foreign derived intangible income" (FDII).[25] The FDII deduction is intended to tax the export-driven (or "foreign-derived") portion of a corporation's intangible income at a reduced rate of 13.125 percent (21 percent multiplied by 62.5 percent of income).[26] The structure of FDII largely mirrors that of GILTI.

A taxpayer first determines total deduction-eligible income – generally the gross income of the corporation (excluding certain specified items) less any allocable deductions, including taxes. They then deduct the deemed tangible income return, which is 10 percent of the adjusted basis of any tangible assets the corporation used to produce deduction eligible income.[27] The result is "deemed intangible income."

Deemed intangible income is then multiplied by the proportion of total deduction-eligible income that is foreign-derived.[28] Foreign-derived income is the portion of gross income from property or services sold or provided to foreign persons.[29] The result is the taxpayer's FDII, eligible for the 37.5 percent deduction.[30]

Uncertainty in Calculations

Several key pieces of these calculations are still subject to pending guidance and regulations from the Internal Revenue Service and Treasury Department. The examples presented below have been simplified in order to highlight specific policy issues arising from the legislation, and any assumptions made in the accompanying calculations should not be taken as a presupposition of any potential regulatory action by the Treasury Department or IRS.

Example 1: Incentives to Move Tangible Assets Overseas

Republicans promised Trump's tax law would end the incentive to ship jobs overseas, but this simple example shows that companies can pay a lower U.S. and global tax rate if they build a new factory (with its accompanying jobs) offshore. This hypothetical also exposes the myth that Trump's tax law imposes a minimum tax of 10.5 percent on any U.S. multinational corporation (through the 50 percent GILTI deduction), with no further tax owed if a foreign jurisdiction imposes a tax of 13.125 percent or more.

In this example, a U.S. corporation has a choice between investing in the U.S or in a low-tax jurisdiction, where it can achieve an effective foreign tax rate of 9 percent. If the U.S. corporation chooses the foreign jurisdiction, the company takes advantage of a deduction equal to 10 percent of its tangible depreciable foreign investment (Qualified Business Asset Investment, or "QBAI").

The first column of Table 1.A. below shows that, without the QBAI deduction, the U.S. GILTI regime bumps this company's global tax rate up from 9 percent to 12.3 percent (which is still below the promised 13.125 percent). The second column shows a lower tax rate with the new factory investment because a $10,000 facility yields a $1,000 QBAI deduction. The QBAI deduction reduces the company's U.S. tax rate from 3.3 percent to approximately 1.5 percent and reduces the company's global tax rate from 12.3 percent to 10.5 percent. For companies with thinner margins the reduction in tax is greater – i.e., the larger the investment overseas, the larger the deduction and the greater the reduction in U.S. tax.

Table 1.A: GILTI Calculation for CFC with 9 Percent Effective Foreign Tax Rate

CFC without Foreign Tangible Investment	
Tested Income	$2,000.00
Foreign Taxes Paid	$180.00
Effective Foreign Tax Rate	9.000%
Deemed Tangible Return	$ -
GILTI Inclusion	$1,820.00
Inclusion Percentage	100.00%
Sec. 78 Gross-up	$180.00
Total GILTI	$2,000.00
GILTI Deduction	$(1,000.00)
Net GILTI	$1,000.00
U.S. Tax on GILTI	$210.00
Allowed Foreign Tax Credits	$(144.00)
Net U.S. Tax on GILTI	$66.00
U.S. Effective Tax Rate	3.300%
Global Effective Tax Rate	12.300%

CFC with Foreign Tangible Investment	
Tested Income	$2,000.00
Foreign Taxes Paid	$180.00
Effective Foreign Tax Rate	9.000%
Deemed Tangible Return	$1,000.00
GILTI Inclusion	$820.00
Inclusion Percentage	45.05%
Sec. 78 Gross-up	$81.10
Total GILTI	$901.10
GILTI Deduction	$(450.55)
Net GILTI	$450.55
U.S. Tax on GILTI	$94.62
Allowed Foreign Tax Credits	$(64.88)
Net U.S. Tax on GILTI	$29.74
U.S. Effective Tax Rate	1.487%
Global Effective Tax Rate	10.487%

Table 1.B. below shows how building the same factory in the U.S. results in higher tax rates, despite the supposed new domestic investment incentive created in the law: the foreign derived intangible income (FDII) deduction. Corporations making new U.S. investments start off subject to the U.S. corporate tax rate of 21 percent. The FDII deduction allows corporations investing in the U.S. to deduct a smaller portion of qualifying income (37.5 percent) than corporations investing offshore (50 percent, as explained above). In addition, the income potentially eligible for the FDII deduction is reduced to the extent it is not tied to exports and to the extent it is tied to tangible domestic investment (e.g., factories and equipment).

In this example, even assuming all the income associated with the factory qualifies for FDII (i.e., 100 percent of the factory's goods are exported and sold to foreign third parties) the tax paid in the U.S. increases to a rate of 17 percent (versus 13.125 in the absence of new tangible investment). Just as increases in foreign tangible investment reduce U.S. tax, larger investment in the U.S. reduces the value of the FDII deduction, potentially increasing U.S. tax.[31]

The result is that this U.S. company pays the least tax if it builds a new factory overseas, effectively sheltering low-taxed income from U.S. tax. Far from eliminating incentives to ship jobs overseas, Trump's tax law builds them into the foundation of the new regime.

Table 1.B: Comparable U.S. Corporation with Exports

U.S. Corp. without Tangible Investment in the U.S.	
Total U.S. Income	$2,000.00
Deduction Eligible Income	$2,000.00
Foreign Derived Income	$2,000.00
Deemed Tangible Return	$ -
Deemed Intangible Income	$2,000.00
Inclusion Percentage	100.00%
FDII Inclusion	$2,000.00
FDII Deduction	$(750.00)
Net U.S. Income	$1,250.00
U.S. Tax	$262.50
U.S. Effective Tax Rate	13.125%
Effective Tax Rate on FDII	13.125%

U.S. Corp. with Tangible Investment in the U.S.	
Total U.S. Income	$2,000.00
Deduction Eligible Income	$2,000.00
Foreign Derived Income	$2,000.00
Deemed Tangible Return	$1,000.00
Deemed Intangible Income	$1,000.00
Inclusion Percentage	100.00%
FDII Inclusion	$1,000.00
FDII Deduction	$(375.00)
Net U.S. Income	$1,625.00
U.S. Tax	$341.25
U.S. Effective Tax Rate	17.063%
Effective Tax Rate on FDII	17.063%

Example 2: Cross-Crediting to Reduce Global Effective Tax Rates

The corporation in this example is typical of many multinational corporations with several CFCs spread across multiple tax jurisdictions.

In this simplified hypothetical, the corporation has a manufacturing facility in a jurisdiction with the same tax rate as the U.S. (CFC 1), with IP held in a low-tax jurisdiction (CFC 2). The two CFCs pay a combined $960 in foreign taxes, for a global effective tax rate of 12 percent.

CFC 1 pays $840 in tax to the high-tax foreign jurisdiction. As CFC 1 is able to deduct the "deemed tangible return" from its manufacturing property and pays a tax rate above the "minimum" set under GILTI, there is no further GILTI tax owed to the U.S., resulting in unused foreign tax credits.

CFC 2 is in a very low-tax jurisdiction subject to the GILTI system, which is designed to tax "global low-taxed intangible income." Here, the foreign effective tax rate is 3 percent, and, after calculating GILTI, the effective U.S. tax rate for CFC 2 is 8.1 percent, with a global effective tax rate of 11.1 percent. Both rates are below GILTI's "minimum" tax of 13.125 percent.

As shown in Table 2.A. below, the combined GILTI tax for the U.S. corporate parent of the two CFCs is $324, for a total U.S. effective tax rate on foreign income of 4.05 percent, and a global effective tax rate (including U.S. taxes) of 16.05 percent.

Table 2.A: GILTI Calculated on a CFC-by-CFC Basis

CFC 1, Manufacturing in Higher-Tax Jurisdiction	
Tested Income	$4,000.00
Foreign Taxes Paid	$840.00
Effective Foreign Tax Rate	21.000%
Deemed Tangible Return	$1,390.00
GILTI Inclusion	$1,770.00
Inclusion Percentage	56.01%
Sec. 78 Gross-up	$470.51
Total GILTI	$2,240.51
GILTI Deduction	$(1,120.25)
Net GILTI	$1,120.25
U.S. Tax on GILTI	$235.25
Allowed Foreign Tax Credits	$(235.25)
Net U.S. Tax on GILTI	**$ -**
U.S. Effective Tax Rate	**0.000%**
Global Effective Tax Rate	**21.000%**

CFC 2, Intangible Property in Low-Tax Jurisdiction	
Tested Income	$4,000.00
Foreign Taxes Paid	$120.00
Effective Foreign Tax Rate	3.000%
Deemed Tangible Return	$ -
GILTI Inclusion	$3,880.00
Inclusion Percentage	100.00%
Sec. 78 Gross-up	$120.00
Total GILTI	$4,000.00
GILTI Deduction	$(2,000.00)
Net GILTI	$2,000.00
U.S. Tax on GILTI	$420.00
Allowed Foreign Tax Credits	$ (96.00)
Net U.S. Tax on GILTI	**$324.00**
U.S. Effective Tax Rate	**8.100%**
Global Effective Tax Rate	**11.100%**

Combined U.S. Tax on GILTI	**$324.00**
Combined U.S. Effective Tax Rate	**4.05%**
Combined Global Effective Tax Rate	**16.05%**

This example company's global effective tax rate of 16 percent is already below the U.S. domestic corporate tax rate of 21 percent. However, the CFC-by-CFC calculation in Table 2.A. actually overstates the level of tax faced by this corporation. Under Trump's tax law, taxpayers calculate GILTI on a global basis, which allows corporations to cross-credit between high- and low-tax jurisdictions. Table 2.B. below shows that this corporation can use the excess credits from CFC 1 to offset tax levied on CFC 2. As a result, the company's global effective tax rate falls from 16.05 percent to 12.72 percent, which reduces the total tax paid to the U.S. from $324 to just $57.78.

As shown in Table 2.C., this cross-crediting (using excess FTCs from high-tax jurisdictions to offset tax levied in low-tax jurisdictions) shields income in low-tax jurisdictions from U.S. tax and perpetuates incentives for U.S. multinationals to stash income in tax havens.

An amendment offered by Democrats during the Senate Finance Committee mark-up of Trump's tax law would have imposed the GILTI tax on a "country-by-country" basis, preventing this type of gaming. The amendment was rejected on a party line vote.

Table 2.B: GILTI Calculated on a Global Basis

CFC 1 and CFC 2 Combined	
Tested Income	$8,000.00
Foreign Taxes Paid	$960.00
Effective Foreign Tax Rate	12.000%
Deemed Tangible Return	$1,390.00
GILTI Inclusion	$5,650.00
Inclusion Percentage	80.26%
Sec. 78 Gross-up	$770.45
Total GILTI	$6,420.45
GILTI Deduction	$(3,210.23)
Net GILTI	$3,210.23
U.S. Tax on GILTI	$674.15
Allowed Foreign Tax Credits	$(616.36)
Net U.S. Tax on GILTI	**$57.78**
U.S. Effective Tax Rate	**0.722%**
Global Effective Tax Rate	**12.722%**

Table 2.C: Comparison of GILTI on a Country-by-Country vs. Global Basis

	Country-by-Country Basis	**Global Basis**
Net U.S. Tax on GILTI	$324.00	$57.78
U.S. Effective Tax Rate	4.05%	0.722%
Global Effective Tax Rate	16.05%	12.722%

Unlike this example company's global effective rate of 12.72 percent, a similar business in the U.S. would pay an effective tax rate of 14.5 percent on foreign-derived intangible income, with a total U.S. effective tax rate of nearly 18 percent.

Even though half the corporation's U.S. income would qualify for the FDII incentive (because of export of products from the manufacturing facility and income tied to U.S.-held IP from foreign sources), its U.S. tangible investment reduces the value of its FDII incentive (as explained in Example 1). The remaining income faces the full U.S. corporate tax rate of 21 percent.

The result is an effective U.S. tax rate of 17.75 percent. This is shown in Table 2.D. below.

Table 2.D: U.S. Corp. with Manufacturing and IP (50% Foreign Sales)

Total U.S. Income	$8,000.00
Deduction Eligible Income	$8,000.00
Foreign Derived Income	$4,000.00
Deemed Tangible Return	$1,390.00
Deemed Intangible Income	$6,610.00
Inclusion Percentage	50.00%
FDII Inclusion	$3,305.00
FDII Deduction	$(1,239.38)
Net U.S. Income	$6,760.63
U.S. Tax	$1,419.73
U.S. Effective Tax Rate	17.747%
Effective Tax Rate on FDII	14.493%

Example 3: Effects of Expense Allocation on U.S. Companies without any Foreign Low-Taxed Intangible Income

The company in this example is a global services or manufacturing company with the bulk of income, investment, and jobs in the U.S. The company has not pursued aggressive tax planning to shift IP or tangible income offshore and has kept its global headquarters and research and development (R&D) investment in the U.S. The company's foreign investments are located where its customers are located, concentrated in high-tax jurisdictions such as Mexico, Germany, and China. The company has both U.S. and foreign debt to finance its operations. Its global foreign effective tax rate is 27 percent.

The new GILTI system is designed to subject foreign income to a minimum tax rate of 13.125 percent. However, existing expense allocation rules require a portion of certain U.S. expenses, including interest, R&D, and headquarters expenses, to be allocated to foreign activity for purposes of determining the company's foreign tax credit limitation (e.g., the GILTI "basket"). These rules, which predate Trump's tax law, are intended to ensure expenses are allocated to the income they economically support.[32]

After allocating a portion of U.S. expenses to foreign operations, the company in this example has a reduced number of FTCs to claim against GILTI tax liability. The result? This company, with no foreign low-taxed intangible income, ends up paying additional tax to the U.S., despite a foreign effective tax rate of 27 percent, well above the new U.S. corporate tax rate of 21 percent. This leads to a global rate of 29 percent, as shown in Table 3.A. below.

Trump's tax law both under-taxes activity it was designed to tax (Examples 1 and 2) and potentially overtaxes companies with no apparent base eroding or inappropriate tax planning (Example 3), depending on the circumstances of the taxpayer.

Table 3.A: Comparison of GILTI Calculation with and without Expense Allocation

	No Expense Allocation	**Full Expense Allocation**
U.S. Source Income	$1,000.00	$1,000.00
U.S. Assets	$3,000.00	$3,000.00
U.S. Interest Expense	$200.00	$200.00
U.S. R&D Expense	$100.00	$100.00
U.S. Headquarters Expense	$50.00	$50.00
Foreign Assets	$1,000.00	$1,000.00
Tested Income (Foreign Source)	$1,000.00	$1,000.00
Foreign Taxes Paid	$270.00	$270.00
Foreign Effective Tax Rate	27.00%	27.00%
Deemed Tangible Return	$ -	$ -
GILTI Inclusion	$730.00	$730.00
Inclusion Percentage	100.00%	100.00%
Sec. 78 Gross-up	$270.00	$270.00
Total GILTI	$1,000.00	$1,000.00
GILTI Deduction	$(500.00)	$(500.00)
Net GILTI	$500.00	$500.00
U.S. Tax on GILTI	$105.00	$105.00
Allowed Foreign Tax Credits	**$(105.00)**	**$(84.00)**
Net U.S. Tax on GILTI	**$ -**	**$21.00**
U.S. Effective Tax Rate	**0.00%**	**2.10%**
Global Effective Tax Rate	**27.00%**	**29.10%**

ENDNOTES

[15] Taxpayers can deduct up to 50 percent of their GILTI under IRC §250. However, this deduction (combined with any potential FDII deduction, see note 30) is limited by taxable income, which can potentially result in a higher GILTI inclusion.

[16] As described further in the examples of this Appendix, the deduction for net deemed tangible return, limitations on foreign tax credits, and rules regarding allocation of expenses result in the GILTI effective tax rate varying greatly from the headline 10.5 percent.

[17] The report focuses on the treatment of C corporations. Individual taxpayers with income through passthrough businesses face a variety of additional restrictions and do not qualify for the same treatment.

[18] IRC §951A(c)(2)(A)(i). Tested income excludes income effectively connected with business in the United States, subpart F income, high-tax income, certain related party dividends, and foreign oil and gas extraction income.

[19] IRC §951A(b)(2) and 951A(d).

[20] IRC §960(d). As an example: a U.S. shareholder with net tested income of $100 and net deemed tangible return of $25 would have $75 of GILTI, and the inclusion percentage would be 75 percent ($75 ÷ $100). To determine its allowable foreign tax credits, this shareholder would take 80 percent of 75 percent of its foreign taxes paid.

$$GILTI\ FTC\ Limit = 0.80 \times \left(Tested\ FTCs \times \left(\frac{Net\ Tested\ Income - QBAI}{Tested\ Income} \right) \right)$$

[21] IRC §904. Foreign tax credits are intended to prevent double-taxation of foreign source income. The §904 limitation is intended to prevent U.S. taxpayers from using their foreign tax credits to offset their U.S. tax liability on U.S. source income. It also prevents cross-crediting between different sources ("baskets") of foreign income (e.g., subpart F income and GILTI). Taxpayers are required to allocate and apportion expenses, including domestic expenses, to determine the income (and thus, allowable FTCs) for each FTC basket.

[22] Taxpayers are also denied the ability to carry any excess foreign tax credits forward or back, further limiting their availability.

[23] IRC §78. This assumes the section 78 gross-up is also subject to the inclusion percentage.

[24] IRC §250(a)(1)(B).

[25] IRC §250(a)(1)(A).

[26] Conference Report, see note 7.

[27] IRC §250(b)(2) and (3).

[28] IRC §250(b)(1). The calculation is expressed as Deemed Intangible Income multiplied by Foreign-Derived Deduction Eligible Income divided by total Deduction Eligible Income:

$$FDII\ = DII \times \left(\frac{FDDEI}{DEI} \right)$$

[29] IRC §250(b)(4).

[30] The FDII deduction (combined with any potential GILTI deduction, see Note 15) is limited by taxable income. To the extent the deduction exceeds taxable income, the deductions shall be reduced proportionately, based on the share of FDII versus GILTI. See IRC §250(a)(2)(B).

[31] This paper focuses on the international tax provisions of Trump's tax law. However, the law also provides a temporary U.S. benefit for depreciation under IRC §168: 100 percent bonus depreciation ("expensing").

Depending on the amount of depreciable basis that qualifies for expensing, the taxpayer could significantly reduce their tax liability in year one. However, the taxpayer must ignore the reduction in depreciable basis caused by expensing for purposes of calculating FDII, increasing their deemed tangible return and reducing their potential FDII deduction.

Over time, this reduced incentive, when combined with the differential between U.S. and foreign tax and other factors, such as restrictions on net operating losses, results in the taxpayer facing higher U.S. tax for a domestic versus foreign investment, even factoring in the one-time benefit of expensing in the law. The example below demonstrates the short term impact of a single year benefit.

	Year 1	**Year 2**
Total U.S. Income	$7,000.00	$7,000.00
Deduction Eligible Income	$897.44	$5,697.44
Foreign Derived Income	$128.21	$813.92
Deemed Tangible Return	$1,000.00	$869.74
Deemed Intangible Income	$ -	$4,827.69
Inclusion Percentage	14.29%	14.29%
FDII Inclusion	$ -	$689.67
FDII Deduction	$ -	$(258.63)
Net U.S. Income	$897.44	$5,438.81
U.S. Tax	$188.46	$1,142.15
U.S. Effective Tax Rate	2.692%	16.316%
Effective Tax Rate on FDII	0%	14.327%

[32] See Note 19 and Treas. Regs. §1.861-8 et seq.