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The Impact of U.S. GILTI and FDII Regimes on Taxation of Intangible Income, Cross-Border Tax Planning, and International Taxation

Master's Thesis
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Abstract

This study examines the GILTI and FDII regimes, which were enacted as part of the comprehensive U.S. tax reform called the Tax Cuts and Jobs Act (TCJA) in late 2017. The study focuses on how the income generated from intangibles is taxed under these regimes and how the regimes affect U.S. MNEs and their cross-border tax planning. In addition, the regimes are analyzed from European point of view and in light of international tax and trade policies. Finally, attention is paid to how the regimes could influence the development of international taxation.

Under the FDII provision, foreign income derived from intangibles is effectively taxed at the rate of 13.125% instead of the statutory corporate tax rate of 21%. On the other hand, pursuant to the GILTI provision, income of CFCs exceeding the deemed annual 10% routine return on tangible assets is effectively taxed at the rate of 10.5% at the level of the U.S. shareholder unless the same income has already been effectively taxed at a sufficient rate in foreign jurisdiction.

Hence, the regimes aim to incentivize the holding of intangibles in the U.S. and encourage U.S. MNEs to export intangible-related goods and services. On the other hand, the regimes aim to discourage the offshoring of intangibles. It is however discovered in the study that, because the FDII and GILTI are calculated based on assumptions, the regimes also affect decisions on the location of tangible assets. In addition, the impact of the regimes on cross-border tax planning depends on several other features such as uncertainties relating to the permanence of the regimes and tax incentives provided by other countries.

There has been doubts whether the FDII regime violates international commitments and constitutes a harmful tax regime or a prohibited export subsidy. For now, the FDII regime has not been challenged in the WTO but it is under peer review in the OECD Forum on Harmful Tax Practices. Due to its innovative approach, the FDII regime significantly deviates from other equivalent measures. Thus, it is impossible to say with certainty whether the regime ultimately constitutes a breach of international commitments.

Ultimately, the GILTI provision is examined with regard to the development of international taxation. First, it has been considered that the GILTI regime has already partly resolved challenges relating to taxation of digital economy. Second, the GILTI provision has served as inspiration for the income inclusion rule, a kind of minimum global tax, which was recently proposed by the OECD.

The GILTI and FDII regimes have given rise to much discussion around the development of international taxation and tax competition, and it is certain that the discussion will continue in the future. It remains to be seen how the GILTI and FDII regimes will ultimately affect the outcome of these discussions.

Keywords international taxation, income taxation, TCJA, GILTI, FDII, intangibles, tax planning

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Työn nimi Yhdysvaltalaisten GILTI- ja FDII-säännösten vaikutus aineettomista saadun tulon verotukseen, rajat ylittävään verosuunnitteluun ja kansainväliseen verotukseen

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Tiivistelmä

Tässä tutkielmassa tarkastellaan GILTI- ja FDII-säännöksiä, jotka säädettiin osana kokonaisvaltaista Yhdysvaltojen verouudistusta nimeltään Tax Cuts and Jobs Act (TCJA) loppuvuodesta 2017. Tutkielmassa keskitytään siihen, miten aineettomista saatua tuloa verotetaan näiden säännösten mukaan sekä siihen, miten säännökset vaikuttavat yhdysvaltalaisiin monikansallisiin konserneihin ja niiden rajat ylittävään verosuunnitteluun. Lisäksi säännöksiä tarkastellaan eurooppalaisesta näkökulmasta ja ottaen huomioon kansainvälinen vero- ja kauppapolitiikka. Lopuksi huomiota kiinnitetään siihen, miten säännökset saattavat vaikuttaa kansainvälisen verotuksen kehittymiseen.

FDII-säännöksen mukaan aineettomista saatua ulkomaista tuloa verotetaan 13,125% efektiivisellä verokannalla sääntömääräisen 21% yhtiöverokannan sijaan. Toisaalta GILTI-säännöksen mukaan väliyhteisöjen tuloa, joka ylittää aineellisen omaisuuden oletetun vuotuisen 10% tuoton, verotetaan 10,5% efektiivisellä verokannalla yhdysvaltalaisen osakkeenomistajan tasolla, ellei samaa tuloa ole jo tosiasiassa verotettu riittävästi vieraassa valtiossa.

Siten säännökset pyrkivät kannustamaan aineettomien pitämiseen Yhdysvalloissa ja kannustavat yhdysvaltalaisia monikansallisia konserneja viemään aineettomiin liittyviä tavaroita ja palveluja ulkomaille. Toisaalta säännökset pyrkivät ehkäisemään aineettomien siirtämistä ulkomaille. Tutkielmassa kuitenkin huomataan, että koska FDII ja GILTI lasketaan oletusten perusteella, säännökset vaikuttavat myös aineellisen omaisuuden sijaintia koskeviin päätöksiin. Lisäksi säännösten vaikutus rajat ylittävään verosuunnitteluun riippuu useista muista tekijöistä kuten säännösten pysyvyyteen liittyvästä epävarmuudesta sekä muiden maiden myöntämistä verohoukuttimista.

FDII-säännöksen osalta on ollut epäilyksiä siitä, rikkooko säännös kansainvälisiä sitoumuksia ja muodostaako se haitallisen verotoimenpiteen tai kielletyn vientituen. Toistaiseksi FDII-säännöstä ei ole haastettu WTO:ssa, mutta se on vertaisarvioitavana OECD:n haitallisten verotoimenpiteiden foorumissa. Innovatiivisuudestaan johtuen FDII-säännös poikkeaa merkittävästi muista vastaavista toimenpiteistä. Siten on mahdotonta sanoa varmuudella, onko säännös lopulta kansainvälisiä velvoitteita rikkova.

Lopuksi GILTI-säännöstä tarkastellaan kansainvälisen verotuksen kehitykseen liittyen. On ensinnäkin katsottu, että GILTI-säännös on jo osaltaan ratkaissut digitaalisen talouden verotukseen liittyviä haasteita. Lisäksi GILTI-säännös on toiminut inspiraationa OECD:n hiljattain ehdottamalle tulon sisällyttämistä koskevalle säännölle, joka toimisi eräänlaisena kansainvälisenä vähimmäisverona.

GILTI- ja FDII-säännökset ovat herättäneet paljon keskustelua kansainvälisen verotuksen kehittämisestä ja verokilpailusta, ja on varmaa, että keskustelu jatkuu tulevaisuudessa. Jää nähtäväksi, miten GILTI- ja FDII-säännökset lopulta vaikuttavat näiden keskustelujen lopputulokseen.

Avainsanat kansainvälinen verotus, tuloverotus, TCJA, GILTI, FDII, aineettomat, verosuunnittelu

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List of Abbreviations

BEPS	Base Erosion and Profit Shifting
CBO	Congressional Budget Office
CFC	Controlled Foreign Corporation
CIT	Corporate Income Tax
CSA	Cost Sharing Agreement
DCF	Discounted Cash Flow
DEI	Deduction Eligible Income
DII	Deemed Intangible Income
DISC	Domestic International Sales Corporation
ETI	Extraterritorial Income
EU	European Union
FATCA	Foreign Account Tax Compliance Act
FDDEI	Foreign Derived Deduction Eligible Income
FDI	Foreign Direct Investment
FDII	Foreign Derived Intangible Income
FHTP	OECD Forum on Harmful Tax Practices
FSC	Foreign Sales Corporation
FTC	Foreign Tax Credit
GATT	General Agreement on Tariffs and Trade
GILTI	Global Intangible Low Taxed Income
HTC Report	OECD Harmful Tax Competition: An Emerging Global Issue
IP	Intellectual Property
IPR	Intellectual Property Right
IRC	Internal Revenue Code

IRS	Internal Revenue Service
MNE	Multinational Enterprise
NDTIR	Net Deemed Tangible Income Return
OECD	Organisation for Economic Cooperation and Development
OECD MTC	OECD Model Tax Convention on Income and on Capital
OECD TPG	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations
QBAI	Qualified Business Asset Investment
R&D	Research and Development
SCM Agreement	Agreement on Subsidies and Countervailing Measures
TCJA	Tax Cuts and Jobs Act
UK	United Kingdom
U.S.	United States of America
U.S.C.	Code of Laws of the United States of America
USD	United States Dollar
WTO	World Trade Organization

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Figure 1 Intellectual Property Rights, Intangible Assets, and Intangibles

Figure 2 Global Intangible Low Taxed Income

Figure 3 Foreign Derived Intangible Income

1 Introduction

1.1 Background

1.1.1 Intangibles and Taxation

The significance of intangibles has rapidly increased in modern business and trade.[1] Value creation is no longer necessarily connected to tangible property such as traditional factories, plants, and physical manufacturing. Moreover, even if central operations of many multinational enterprises (MNEs) are still connected to tangible assets, it does not exclude the use and importance of intangibles. Affected by prevailing competitive situation in the markets, MNEs aim to constantly enhance their activities and identify new opportunities. Hence, technological innovations are often exploited to facilitate and speed up traditional manufacturing.

The increased importance of intangibles has been noted in a study which compared the book value and stock market value of the top 150 U.S. companies. In 1984, the book value corresponded to approximately 75% of the company's stock market value. However, by year 2005 it had dropped to 36%. The remaining value, in 2005 almost two thirds, lies in the companies' intangible assets.[2] Taking into consideration how rapid technological development has been, it can be assumed that nowadays intangibles represent even larger share of the companies' stock market value. It is said that U.S. companies derive 80% of market value from intangible assets and own the majority of the world's intellectual property.[3]

The role and significance of intangibles also depend on how the they are defined. When discussing intangible assets, the focus has traditionally been on intellectual property, which can be subject to legal rights by establishing for example copyrights, trademarks, and patents. However, the definition of intangibles is much broader and extends to intellectual

[1] See for example Dischinger – Riedel 2011 p. 691.
[2] Shapiro – Pham 2007 p. 5.
[3] Beller 2018 p. 37.

capital. Thus, the intangibles as we perceive them nowadays include also for example workforce, know-how, and customer lists.[4]

As the intangibles increasingly contribute to MNEs' value creation, they have also become subject to greater interest in taxation and accounting. On the other hand, the transfer of intangible assets has been quite effortless due to their non-physical nature and vague perceivedness, and MNEs have often ended up offshoring intangibles to remote tax havens.[5] Consequently, there has been even aggressive tax competition between countries that have aimed to become an attracting location for MNEs and their intangibles. Various countries have implemented patent box regimes and other national tax incentives, the purpose of which is to attract intellectual property to their territory in the hope that educated people, know-how, and corporate and personal income streams will follow. Tax competition has taken place for example between the United States of America (U.S.) and the European Union (EU), but also between different EU Member States.

Furthermore, the constant development of intangibles and their usage possibilities rapidly outdates tax law. Recent developments both in stipulated tax law and case law often relate to intangibles. This is also the case with the topic of this study, the so called GILTI and FDII provisions. These provisions stipulate the taxation of income deemed to be generated from intangibles. The provisions were recently enacted in the U.S. as part of an extensive federal tax reform under the name of the TCJA.

1.1.2 Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act (TCJA) was signed into law by President Trump on December 22, 2017 and became Public Law No. 115-97.[6] The TCJA amended the Internal Revenue Code (IRC)[7] of 1986 to a large extent. The main objectives of this extensive tax reform were to grow the American economy and to simplify the complex federal tax system.[8] However,

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[4] Wiederhold 2014 p. 36. The definition of intangibles will be discussed in more detail in Chapter 2.
[5] For example, based on a study that covered more than 14,000 MNEs in twelve OECD countries, technology intensive manufacturing MNEs that have significant level of intangibles are more likely to own subsidiaries in tax havens. See Jones – Temouri 2016 p. 238.
[6] The Act was actually signed into law with a title "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018", but it is often referred to as the TCJA according to the title that was used when the Act was drafted. The abbreviation TCJA is used also in this study for reasons of clarity.
[7] The IRC includes nearly all federal tax laws and is published as Title 26 of the U.S. Code. Unless otherwise specified, all the following references to stipulated law are made to Sections of Title 26.
[8] The Goals of Donald J. Trump's Tax Plan p. 1.

the final impact on economy remains to be seen. It is also unclear whether the tax system was after all simplified.[9] Although the TCJA clarified the system to a certain extent, it also introduced many new provisions and exceptions, some of them being in force temporarily until 2026.[10]

The TCJA broadly covers various aspects of federal and cross-border taxation. As the U.S. has a central position in world trade and business, the TCJA is expected to have a profound impact on international business markets. Perhaps the most essential amendments introduced by the TCJA in this regard are the reduced U.S. federal corporate income tax (CIT) rate from 35% to 21% and the transition from worldwide tax system to principle of territoriality. Under the worldwide taxation, all income received by U.S. persons was taxable in the U.S. Accordingly, income earned by foreign subsidiaries of U.S. MNEs was subject to tax in the U.S. at the latest when it was repatriated. This encouraged U.S. MNEs to retain profits abroad in order to defer U.S. taxation.[11] Under the new tax system based on territoriality, in principle only income generated in the U.S. is subject to U.S. tax, and dividends paid by foreign subsidiaries to their U.S. parents are fully deductible under the participation exemption rule provided that certain conditions are met.[12]

Apart from the general impact, the TCJA is also assumed to have a direct impact in the field of international taxation, as it broadly addresses issues that were originally discussed in the Base Erosion and Profit Shifting (BEPS) project carried out between 2013 and 2015 by the Organisation for Economic Cooperation and Development (OECD) and G20 countries. Indeed, the OECD has acknowledged that the TCJA constitutes a comprehensive attempt to address the challenges identified in the BEPS Action Plan and that the U.S. has gone a long way in implementing BEPS measures.[13] Many provisions introduced as part of the TCJA

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[9] This has also been noted by commentators, who have considered that the simplification of the tax system does not seem to have had a central role in the tax reform. See Viitala – Ahonen 2018 p. 6.

[10] Several provisions of the TCJA contain a so called sunset clause, i.e. they are temporarily in force, because the TCJA was enacted through the budget reconciliation process. This allowed the Republicans to pass the bill alone with a simple majority and with no votes from the Democrats. However, pursuant to the so called Byrd Rule stipulated in Section 313 of the Congressional Budget Act, the reconciliation bill cannot add to the federal deficit outside of the application period of the bill, which is typically 10 years. In their 2018 budget proposal, the Senate Budget Committee allowed for USD 1.5 trillion deficit. Thus, the TCJA needed to be drafted in a manner that its ultimate financial impact would remain within the limits set out by the Senate.

[11] According to a presented estimation, the Fortune 500 Companies held up to USD 2.6 trillion offshore in 2017, prior to the enactment of the TCJA. See ITEP 2017 p. 1.

[12] Pursuant to Section 245A and Section 246(c)(5), the qualification for participation exemption requires that the U.S. shareholder has held at least 10% of the stock of the foreign corporation for at least 366 consecutive days.

[13] OECD Economic Survey of the U.S. 2018 p. 47; Aldonas 2019 p. 877.

prevent base erosion and profit shifting. However, the tax reform also contains protectionist features.[14] These features have already led to discussions on whether the tax reform is fully in conformity with all international commitments. Furthermore, it remains to be seen whether these changes adopted by the U.S. could lead to countermeasures and more fierce tax competition between countries.

The introduction of participation exemption could lead to inappropriate offshoring and tax base erosion. To balance the situation, the TCJA also introduced several provisions to discourage such activities. With regard to income generated from intangibles, the most significant amendments are the GILTI provision, which stands for Global Intangible Low Taxed Income, and the FDII provision, standing for Foreign Derived Intangible Income. This study focuses on these two provisions.

Under the GILTI provision, interpreted as the "stick", U.S. shareholders of controlled foreign companies (CFC) shall be taxed on the income of their CFCs that exceeds the deemed return on CFCs' tangible assets, i.e. the remaining income that is deemed to be derived from intangibles. The other side of the coin is the FDII provision, which constitutes the "carrot". Pursuant to the FDII provision, foreign income of U.S. corporations deemed to be generated from intangible-related foreign sales may be partially deducted and is thus taxed at a lower effective CIT rate in the U.S. Together these provisions aim to encourage intangible investments and holding of intangibles in the U.S. and prevent their offshoring.

1.2 Scope of the Study

In this study, the taxation of intangible income, cross-border tax planning, and international taxation will be examined in light of the newly introduced GILTI and FDII provisions. First, the objective is to clarify how intangible income is taxed under these provisions. Second, the possible impact of GILTI and FDII provisions on U.S. MNEs and their cross-border tax planning will be analyzed in more detail.

Finally, due to the cross-border nature of the topic, the study aims to recognize possible implications from European point of view. It will be examined whether the provisions violate certain international commitments in the field of tax and trade policies and what is the impact of the provisions on the development of international taxation. Specific attention will be paid

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[14] Viitala – Ahonen 2018 p. 13.

to whether the FDII provision could be considered to constitute a harmful tax regime or a prohibited export subsidy. On the other hand, it will be also analyzed whether European countries are under pressure to provide similar tax incentives or take other countermeasures in order to keep up their position in the tax competition. In this context, the FDII provision will be shortly compared with patent box systems provided by various EU Member States.

In summary, this study focuses on the following research questions:

1. How do the GILTI and FDII provisions affect the taxation of income generated from intangibles?
2. How do the GILTI and FDII provisions possibly impact the tax planning of U.S. MNEs in the future?
3. What implications could the results to the first and second research question have from European point of view and how could European countries react to them?

The research will be carried out first from U.S. point of view, as the focus will lie on the effects of the amendments on taxation and tax planning of U.S. MNEs. Later on, attention will be paid to potential implications abroad. In this context, European point of view will be adopted.

1.3 Research Methods and Sources of Law

The legal dogmatic method has been selected as the main research method in this study. Hence, the study constitutes a legal study where the aim is to systemize and interpret existing legal norms, *de lege lata*.[15] The systematization of legal norms forms the theoretical legal dogmatic method, whereas the interpretation, the purpose of which is to present justified statements on the interpretation of the law, represents the practical side of the method.[16]

Tax law is also strongly influenced by various non-legal factors, which may affect both the stipulation of the law and how it is interpreted. Tax planning, fiscal interests, and other tax-motivated factors are clearly attached to the topic of this study. Thus, the topic will be analyzed also from a broader economic and political point of view, taking into consideration

[15] Hirvonen 2011 p. 22.
[16] Aarnio 1997 p. 36–37.

for example various incentives behind stipulated tax legislation, possibilities in cross-border tax planning, and tax competition between countries.

In addition, comparative legal method is used where applicable. Legal comparison will be conducted in assessing whether the FDII provision and tax incentives it provides for U.S. MNEs differ from the tax incentives offered by certain EU Member States. Taking into consideration the purpose of the comparison, the comparative research of this study is brief and simplified. It will be carried out on micro level and can be characterized as multilateral and purely functional.[17]

The main source of law in this research is naturally the TCJA and, more specifically, the GILTI and FDII provisions. Furthermore, attention will be paid to official documentation issued at the time of enactment and afterwards, the purpose of which is to clarify and specify the TCJA and said provisions. As the study concerns a recent legislative amendment, there is not yet case law in this regard. However, the implications of the TCJA have already been discussed by various commentators in legal literature, and the literature will thus be an essential source for this study.

Furthermore, international sources will be exploited when analyzing the topic from a more global perspective. Specific attention will be paid to OECD BEPS reports and other relevant documentation issued by the OECD, as well as the World Trade Organization's (WTO) Agreement of Subsidies and Countervailing Measures (SCM Agreement). Additionally, attention will be paid to relevant domestic legislation when analyzing certain European patent box systems for the purpose of a legal comparison.

1.4 Outline of the Study

The study begins with an overview of intangibles in Chapter 2. The definition of intangibles as well as their transfer and valuation will be covered shortly to provide a general perception of intangibles. In addition, recent U.S. case law and changes with regard to valuation and identification of intangibles will be discussed. The examination of intangibles at a general level serves as background information for following chapters.

[17] Husa 2013 p. 125–130; 134–136; and 145–156.

The GILTI and FDII provisions will be described in detail in Chapter 3. The purpose of this chapter is to lay out legal framework and clarify how the provisions affect the taxation of intangible income. Thus, the first research question will be replied to in this chapter. Specific attention will be paid to how the income treated as GILTI or FDII is calculated and how it is effectively taxed.

In Chapter 4, preliminary results obtained in the previous Chapter 3 will be further examined in light of tax planning. The chapter will focus on how the GILTI and FDII provisions could impact tax planning carried out by U.S. MNEs. The aim is to identify any possible incentives and disincentives that the provisions could have in tax planning. The second research question will be replied to in chapter 4.

After examining the topic from U.S. perspective, European point of view will be adopted in Chapter 5. The focus of the chapter will lie on analyzing GILTI and FDII provisions and their influence on tax planning, i.e. the answers to the first and second research question obtained in Chapters 3 and 4, correspondingly, at a more global level. The FDII provision and its international impact will be examined in more detail in light of international tax and trade policies. For this purpose, the chapter will include a brief legal comparison between the FDII provision and certain European patent box systems. In addition, it is examined how the GILTI provision could influence the future international taxation. The chapter will provide a reply to the third research question.

The study ends with a conclusion in Chapter 6. The chapter contains further analysis of the information obtained in this study, concluding remarks, and a glance into the future.

2 Definition, Transfer, and Valuation of Intangibles

2.1 Definition

Intangibles are literally items we cannot touch. A more accurate definition of intangibles depends widely on the scope and context. There are also multiple similar terms such as intellectual assets, intellectual property, intangible assets, and intangible property, which can have the same, similar, or overlapping meaning. In this chapter, intangibles are discussed purely in legal and tax context and the purpose of this chapter is not to provide an extensive analysis of intangibles but a simple definition and short introduction. For understanding better the underlying motives relating to the topic of this study, specific attention will be paid to recognition, valuation, and transfer of intangibles under the OECD and U.S. transfer pricing rules.

Intangibles that are protected by certain established legal rights become intellectual property (IP). Thus, their possession becomes visible: being property means that the ownership of assets can be asserted over. On the other hand, not all intangibles may be protected by establishing legal rights. For example workforce has a central role in the MNEs' success. However, while the staff is an intangible asset of an MNE, it is not property as it cannot be owned like other tangible or intangible items. The workforce can neither be subject to legal rights, but it does create ideas, products, and other items that may then be subject to legal rights. Thus, intellectual capital consists of both the workforce and the intellectual property, and it can be traded.[18]

Intangibles have interesting features that distinguish them from other assets. For example, they can be exploited without being depleted. Thus, products created from intangibles typically result in higher earnings margins since production costs are lower.[19] Basically anything that increases the value of a product or the company and is not a tangible or financial asset could be interpreted as an intangible. This means that there is also endless amount of different intangibles. For example, *Wiederhold* has presented 12 different categories of intangibles. These categories cover intangibles from trademarks and design

[18] Wiederhold 2014 p. 3–4; 36; and 39–40.
[19] Wiederhold 2014 p. 35–36.

documents to competitive position and essential goodwill.[20] Another illustration of various examples of intangibles is given by *Alder & Sound* and presented below in Figure 1. The illustration shows that all intellectual property rights (IPR) and intangible assets are intangibles, and all intellectual property rights are intangible assets. However, not all intangible assets are IPR and not all intangibles are intangible assets or IPR.

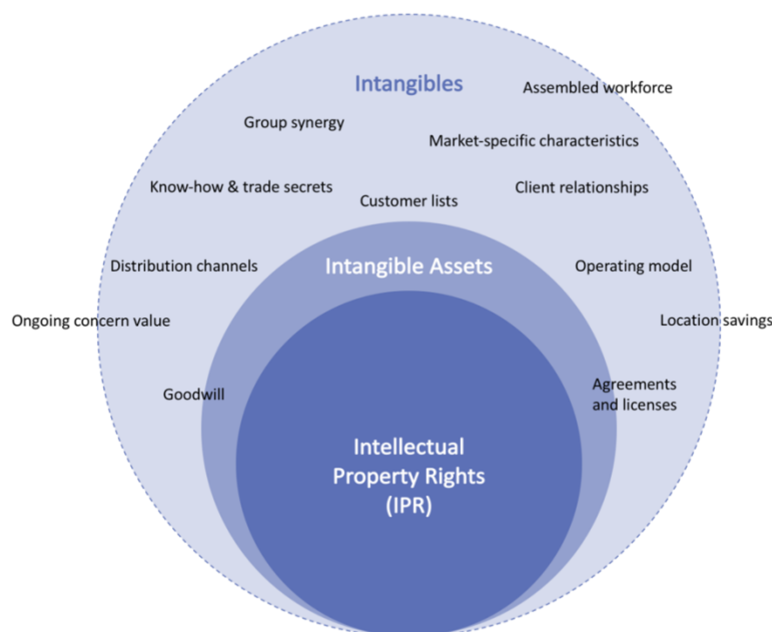

Figure 1. *Intellectual Property Rights, Intangible Assets, and Intangibles.*

Photo credit: *Alder & Sound.*

Both the OECD Transfer Pricing Guidelines (OECD TPG) and U.S. tax legislation contain a definition of intangibles. Pursuant to Paragraph 6.6 of the OECD TPG, intangible is any asset which is not physical or financial; which is capable of being owned or controlled for use in commercial activities; and whose use or transfer would be compensated had it

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[20] The 12 categories listed by *Wiederhold* are as follows: personnel or workforce; unique business and technical development and manufacturing processes; essential goodwill; trademarks, including Internet domain names; competitive position; orders; exclusive contracts; valuable contracts; research and development completed or acquired; research and development currently in process, including acquired R&D; design documents; and software and databases. See Wiederhold 2014 p. 52.

occurred in a transaction between independent parties in comparable circumstances. It is explicitly mentioned that, instead of focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction. Thus, intangibles have been given a broad definition and basically any assets that meet with the three conditions can be treated as intangibles, the transfer or use of which should be compensated between related parties. To illustrate the various types of different intangibles, the OECD TPG also shortly presents eight different categories of intangibles[21], accompanied by a remark that the list is not even meant to be comprehensive.

Compared with the OECD TPG definition, intangible property has been given a slightly more accurate statutory definition in the U.S. tax legislation, although the scope remains wide. Pursuant to Section 936(h)(3)(B), the term "intangible property" means any (i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; (vi) any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment); or (vii) any other item the value or potential value of which is not attributable to tangible property or the services of any individual.

Subparagraphs (vi) and (vii), which significantly broaden the definition, were recently amended as part of the TCJA. Unlike the definition given in the OECD TPG, the definition in the U.S. tax legislation begins with a detailed listing of intangibles. However, especially the residual category of subparagraph (vii) covering any similar item in fact broadens the scope to cover basically any assets the value of which is not attributable to tangible property or services of individual. Thus, these two definitions can be considered to be more or less identical.

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[21] These categories are patents; know-how and trade secrets; trademarks, trade names and brands; rights under contracts and government licenses; licenses and similar limited rights in intangibles; goodwill and ongoing concern value; group synergies; and market specific characteristics. See Paragraphs 6.18–6.31 of the OECD TPG.

2.2 Recognition and Valuation in Transferring Intangibles

The definition of intangibles is of relevance especially when intangibles are being transferred and need to be recognized. The transfer of intangibles has become of particular interest in taxation due to various reasons. First, they have increasing role in the business and value creation. Second, they are also easy to transfer at least on paper. On the other hand, endless types of different intangibles also makes it hard for taxpayers to recognize and value intangibles, and thus additional guidance is required.

Typically the transfer of IP within an MNE takes place in form of licensing, which allows several group companies to exploit the same IP in their business. All or majority of the IP of an MNE may also be centralized in an IP holding or principal company, the (possibly sole) purpose of which is to hold, administer, and control the IP. The company then grants licenses to operative group companies, allowing them to exploit the same IP in their business. The centralization has many redeeming features, such as easier management and protection of the intangibles.[22] Furthermore, since the IP holding company is typically located in a low tax jurisdiction, the centralization, sale, and licensing of intangibles in intra-group transactions are also efficient tax planning and profit shifting tools for MNEs. On the other hand, group companies may also exploit other common intangibles apart from IP. However, under the OECD TPG, an appropriate compensation should be paid for the use of any intangible.

Valuation methods are used to determine an appropriate compensation for intangibles subject to transfer or exploitation. When it comes to transactions between unrelated parties, the value agreed upon is based on negotiations. The parties would not have any incentive to pay over or receive less than the market value of intangibles, so called arm's length value. Thus, the valuation of intangible assets is generally simple and in conformity with market conditions.

However, between related parties, typically companies belonging to the same group of companies, specific attention needs to be paid to the valuation of intangibles. As stated out in Paragraph 6 of the OECD TPG, the starting points in the OECD TPG are the separate entity approach and the arm's length principle. In addition, under the OECD TPG, the compensations paid in intra-group sales and licensing need be at arm's length. This prevents

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[22] Penttilä – Isomaa-Myllymäki 2018 p. 82–83.

profit shifting from one company and country to another. According to the arm's length principle set forth in Article 9 of the OECD Model Tax Convention (MTC), if the conditions between related parties in their commercial or financial relations deviate from those which would have been made between independent parties, the transaction may be adjusted and the parties taxed accordingly. For this purpose, the OECD TPG presents several valuation methods, the suitability of which depend on the situation at hand.[23] However, finding the right arm's length value and even recognizing all the intangibles involved may be very challenging.

The U.S. tax legislation also stipulates valuation of intangibles and possible adjustments in transfers. Adjustments may be made in related party transactions under Section 482, which stipulates allocation of income and deductions between related taxpayers. In addition, it was recently amended by the TCJA that transfers of intangible property may be required to be valued on an aggregate basis or on the basis of realistic alternatives, if that is considered to be the most reliable means of valuation for such transfers. This implies that there is a strong tendency to regard the transferred intangibles as a whole, which typically increases their overall value.

2.3 Recent Changes

International taxation has been greatly influenced by the recent OECD BEPS Project, which took place between 2013 and 2015. One of the key issues under discussion in the OECD BEPS was the alignment of allocation of profits with the economic activities producing profits, i.e. value creation. The conclusions regarding this matter were published in BEPS Action 8–10 Final Report. As for intangibles, the report explicitly states that the legal owner of intangibles should no longer be automatically entitled to the accrued return generated by those intangibles. Instead, group companies performing important functions, contributing assets, and controlling economically significant risks should be entitled to an appropriate

[23] The OECD TPG mentions the comparable uncontrolled price method, the resale price method, and the cost plus method, which are traditional transaction methods, and in addition transactional net margin method and the transactional profit split method, which are transactional profit methods. Pursuant to Paragraph 2.2 of the OECD TPG, the selection of a method depends *inter alia* on the nature of the controlled transaction, the availability of reliable information, and how appropriate the application of each method, taking into account their recognized strengths and weaknesses, would be with regard to the transaction. For more information on these methods, see Chapter II (p. 97–146) of the OECD TPG.

return that reflects the value of their contributions.[24] The underlying aim is to ensure that the profits will accrue and be taxed where the people and other assets generating the profit are located.

The suggestions presented in the BEPS Action 8–10 final report were amended to the latest version of the OECD TPG[25] in 2017. Consequently, pursuant to Paragraph 6.32 of the OECD TPG, the ownership of intangibles and allocation of profit generated from intangibles are subject to extensive analysis, where attention is paid to the parties' performed functions, used assets, and assumed risks. Specific attention is paid to so called DEMPE functions, standing for the development, enhancement, maintenance, protection, and exploitation of intangibles. Hence, although the legal rights and contractual arrangements are still the starting point pursuant to Paragraph 6.35 of the OECD TPG, contributions by other group members entitle them to a compensation.

The above has to be taken into consideration in the exploitation and transfer of intangibles, too. Thus, the mere transfer of legal ownership is no longer sufficient. For the recipient to be entitled to all profits generated from intangibles, the actual functions, assets, and risks related thereto, i.e. economic substance, must also be transferred. The introduction of DEMPE functions is especially relevant for the MNEs that have implemented principal or IP holding company structures.[26]

With regard to the valuation of intangibles in outbound restructurings and intercompany pricing under the U.S. tax legislation, the TCJA amended Sections 367(d) and 482 by adding a realistic alternative principle clause. Pursuant to this new clause, the valuation of transfers of intangible property shall be made on an aggregate basis or on the basis of realistic alternatives, if it is determined that such basis is the most reliable means of valuation of certain transfer. The purpose of the aggregate approach is to take into consideration the additional value resulting from the interrelation of intangible assets where appropriate. In addition, the realistic alternative principle is based on the assumption that a taxpayer will only enter into a certain transaction if none of its realistic alternatives is economically preferable.[27]

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[24] BEPS Action Plan 8–10 p. 10.
[25] See Paragraph 19 of the OECD TPG.
[26] See in-depth analysis of the amendment's impact on IP holding company structures, Penttilä – Isomaa-Myllymäki 2018.
[27] Conference Report 2017 p. 661–662.

Both TCJA amendments, the broadened scope of intangibles and the realistic alternative principle, aim to limit base erosion and profit shifting by means of intangible property transfers. As a consequence, the amendments can be expected increase the overall value of intangibles subject to transfer or licensing. In addition, the Conference Report explicitly mentions that these amendments were introduced in response to certain controversies arisen in case law.[28] For example, there has been case law where the consideration of workforce as an intangible asset and subsequent duty to compensate for it as well as the use of realistic alternatives have been denied despite the Internal Revenue Service's (IRS) attempts.

In *Amazon v. Commissioner*, where the Tax Court issued opinion in March 2017, Amazon US had granted Amazon Lux the right to use certain pre-existing intangible assets in Europe by entering into a cost sharing arrangement (CSA). The buy-in payment was determined based on the comparable uncontrolled transaction method. However, the IRS argued that the discounted cash flow (DCF) method should have been used instead based of the aggregation of transactions. Consequently, the buy-in payment would have been based on the enterprise value for Amazon's European business instead of the separate intangible assets transferred under the CSA, and thus result in a significantly higher buy-in payment. The Tax Court held that such approach was not appropriate as it included the value of many items that were not treated as intangibles under the former legislation. Namely, these assets were workforce in place, going concern value, and goodwill.[29]

Moreover, the IRS could not justify its approach by referring to the "realistic alternatives" principle. The company had been entitled to make the cost sharing election under the law and the opted structure did not lack economic substance. Thus, the IRS was not allowed to replace the structure opted by Amazon US based on the fact that the company had had realistic alternative available to it.[30] This was in line with the Tax Court's previous view in *Veritas v. Commissioner,* where the Tax Court held that the IRS was not authorized to determine the buy-in payment of a CSA by using the DCF or income method and thus aggregating the transactions and treating them as a sale.[31]

As the opinions issued by the Tax Court have precedential value, their alignments would have established how similar transfers of intangibles shall be valued, had the TCJA

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[28] Conference Report 2017 p. 661–662.
[29] Amazon v. Commissioner 2017 p. 78–80.
[30] Amazon v. Commissioner 2017 p. 82–84.
[31] Veritas v. Commissioner 2009 p. 40–41.

amendments not been introduced. Thus, it seems that the legislator has been keen to change the legal praxis by introducing these "missing" stipulations in the IRC. It can be assumed that these amendments will significantly influence the transfer of intangibles and their valuation. As a result of the amendments, in the future transfers of intangibles can be expected to be treated more frequently as a whole instead of separate intangibles, and this often leads to higher total value.[32] Hence, the amendments discourage transfer of intangibles and make the estimation of real arm's length value challenging.

[32] Viitala – Ahonen 2018 p. 11.

3 GILTI and FDII Provisions

3.1 Global Intangible Low Taxed Income

3.1.1 U.S. Shareholder and CFC

The most significant amendments of the TCJA concerning the taxation of income derived from intangibles are undisputedly the GILTI and FDII provisions. The provision regarding global intangible low-taxed income (GILTI) is stipulated in Section 951A. Pursuant to Section 951A(a), each person who is a U.S. shareholder of any controlled foreign corporation (CFC) for any taxable year shall include in gross income the shareholder's global intangible low-taxed income for the year.

Whether a U.S. person is considered shareholder of a CFC is determined separately for each taxable year of the CFC which ends in or with taxable year of such U.S. shareholder. Pursuant to Section 951(b), U.S. shareholder refers to a U.S. person who owns at least 10% of the total combined voting power of such foreign corporation or at least 10% of the total value of shares of such foreign corporation. Based on the definition given in Section 957(a), a CFC is any foreign corporation where more than 50% of the total combined voting power or the total value of the stock is owned or considered as owned by U.S. shareholders on any day during the taxable year of such foreign corporation. Pursuant to Section 951A(e)(2), a person shall be treated as U.S. shareholder of a CFC for any taxable year of such person if the person owns stock in such foreign corporation on the last day in the taxable year of such foreign corporation, on which such foreign corporation is a CFC. A foreign corporation shall be treated as CFC for any taxable year if such foreign corporation is a CFC at any time during such taxable year.

The GILTI provision creates a new type of income of CFCs alongside subpart F income and concerns all U.S. shareholders of CFCs, despite the legal form of the U.S. shareholder. The GILTI provision is applied to the CFCs' taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which

such taxable years of foreign corporations end.[33] Consequently, the GILTI provision will be first applied in the taxation carried out in 2019.

3.1.2 Calculation of GILTI

Pursuant to Section 951A(b)(1), GILTI means the excess, if any, of a U.S. shareholder's net CFC tested income for a taxable year over the net deemed tangible income return of the same shareholder for the same taxable year. This is illustrated in the figure below:

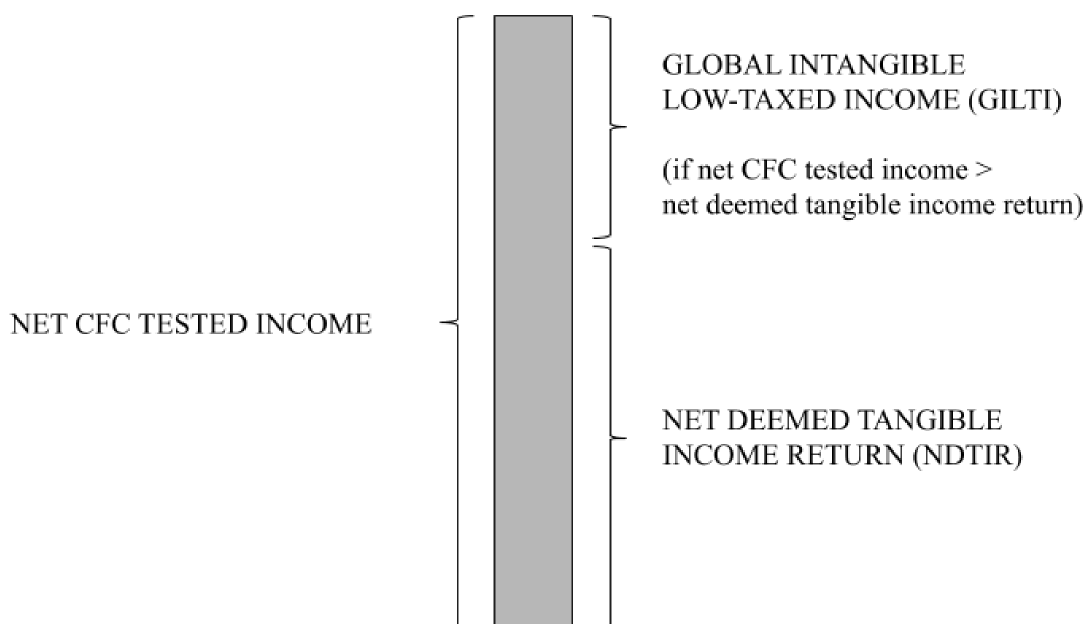

Figure 2. *Global Intangible Low Taxed Income.*

Pursuant to Section 951A(c), the net CFC tested income refers to the excess, if any, of the aggregate of the U.S. shareholder's pro rata share of the tested income of each CFC over the aggregate of such shareholder's pro rata share of the tested loss of each CFC. The calculations based on pro rata shares are conducted in the same manner as the calculation of subpart F income, i.e. under the rules of Section 951(a)(2).

[33] Conference Report 2017 p. 163.

The tested income in turn means, with respect to any CFC for any taxable year, the excess of gross income over the deductions, including taxes, allocable to such gross income. The gross income is taken into account without regard to certain categories of income which would skew the calculation. The categories to be excluded from gross income in the calculation of tested income are for example the subpart F income and dividend received from a related person.[34] The tested loss has the opposite meaning, i.e. it refers to the excess, if any, of deductions, including taxes, properly allocable to the gross income over that gross income with respect to any CFC for any taxable year.

Pursuant to Section 951A(b)(2), the net deemed tangible income return (NDTIR) means the excess of 10 percent of the aggregate of the U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC.[35] It is calculated over the amount of interest expense to the extent the interest income attributable to such expense is not taken into account in determining the shareholder's net CFC tested income. Thus, the NDTIR is basically a deemed 10% routine return on the QBAI.

The qualified business asset investment (QBAI) refers to the specified tangible property, i.e. any tangible property used in the production of tested income, used in a trade or business of the corporation and of a type with respect to which a deduction is allowable under Section 167. The QBAI is calculated based on the average of the CFC's aggregate adjusted bases as of the close of each quarter of the taxable year. In case of dual use property, i.e. property used both in the production of tested income and other income, the property shall be treated as specified tangible property in the same proportion that the tested income produced with respect to such property bears to the total gross income produced with respect to such property.

It is an interesting feature that the amount of GILTI is essentially calculated on an aggregate basis and not separately for each CFC of a U.S. shareholder. The initial calculations, i.e. the

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[34] The entire list of categories to be deducted from gross income for the purpose of calculating the tested income pursuant to Section 951A(c)(2)(A)(i) is as follows: any item of income described in Section 952(b); any gross income taken into account in determining the subpart F income; any gross income excluded from the foreign base company income (as defined in Section 954) and the insurance income (as defined in Section 953) by reason of Section 954(b)(4); any dividend received from a related person (as defined in Section 954(d)(3); and any foreign oil and gas extraction income (as defined in Section 907(c)(1).

[35] Some have considered that the 10% deemed return on tangible assets is quite high. However, it has also been pointed out that, taken into consideration that the GILTI provision does not allow carryforward to balance the amount of GILTI each year, the expected 10% rate of return on equity is actually not that excessive. See Singh – Mathur 2018 p. 16–18.

amount of tested income or tested loss as well as the QBAI are conducted separately for each CFC. However, the NDTIR as well as the net CFC tested income, which ultimately determine the amount of GILTI, are taken into consideration in the aggregate. This might have a neutralizing effect on the final GILTI tax, but it may also skew the final result, as it allows pooling and encourages U.S. MNEs to operate both in high-tax jurisdictions and tax havens to offset the GILTI tax.[36]

Pursuant to Section 951A(d)(4), the Secretary is entitled to issue regulations or other guidance for the purpose of preventing the avoidance of the purposes of the subsection concerning QBAI. It has been particularly mentioned that such regulations could provide for the treatment of property if such property is transferred or held temporarily, or if the avoidance of the purposes of the paragraph is a factor in the transfer or holding of such property.

As expected, the Proposed GILTI Regulations released in September 2018 addressed QBAI anti-abuse rules alongside other guidance and narrowed the accumulation of QBAI under certain circumstances. Pursuant to Section 1.951A-3(h)(1) of Proposed GILTI Regulations, specified tangible property is disregarded in determining the QBAI if the CFC acquires it with a principal purpose of reducing the GILTI inclusion amount and holds the property temporarily but over at least one quarter end. For purposes of this paragraph, property held for less than 12 months including at least one quarter end, is treated as temporarily held and acquired with a principal purpose of reducing the GILTI inclusion amount of a U.S. shareholder. Moreover, pursuant to Section 1.951A-3(h)(2), a transfer of any specified tangible property transferred by one CFC to another CFC during the period after December 31, 2017 and before the transferor CFC's first year to which the GILTI provision applies, will be disregarded in the calculation of the transferee CFC's QBAI. As a final note, Section 1.951A-1(d)(3)(ii) stipulates a special limitation rule for preferred stock in case of excess QBAI, according to which the amount of QBAI is limited to 10 times the tested income. Together, these proposed regulations limit the interpretation of QBAI and prevent the misuse of the subsection.

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[36] Harris – Looney 2018 p. 14; Clausing 2018 p. 19.

3.1.3 Taxation of GILTI

It results from the inclusion of GILTI to the U.S. shareholder's gross income that the amount of GILTI is subject to tax in the U.S. For U.S. MNEs, it means that the GILTI would be subject to CIT at the rate of 21%. However, a deduction is allowed under Section 250(a), pursuant to which a domestic corporation is allowed to deduct 50% of the GILTI included in the gross income of such domestic corporation under Section 951A. This leads to an effective tax rate of 10.5% on income treated as GILTI. The deduction rate shall be reduced to 37.5% for taxable years after 2025 pursuant to Section 250(a)(3)(B). Consequently, the amount of GILTI, if any, will be effectively taxed at the rate of 13.125% in taxable years after 2025.

In addition, domestic corporations as U.S. shareholders of CFCs are entitled to a foreign tax credit (FTC) corresponding to 80% of the taxes that have been paid abroad for the income treated as GILTI.[37] Pursuant to Section 960(d), such domestic corporations shall be deemed to have paid foreign income taxes equal to 80 percent of the product of such domestic corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued by CFCs. The inclusion percentage means the ratio of the corporation's GILTI divided by the aggregate amount of the tested income of the CFCs. The tested foreign income taxes mean foreign income taxes paid or accrued by such foreign corporation, which are properly attributable to the tested income of such foreign corporation, taken into account by the domestic corporation under the GILTI provision.

The 80% FTC for GILTI is separate from other foreign tax credits.[38] In other words, foreign taxes on other income than GILTI cannot be resorted to in the taxation of GILTI. The FTC for GILTI means that the amount of GILTI is not in principle taxed in the U.S. if the same income has already been taxed at the rate of 13.125% or higher by a foreign jurisdiction.[39] According to Section 1.960 of the Proposed FTC Regulations, the FTC for GILTI is calculated strictly and only such foreign income taxes of a CFC that are associated with the

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[37] Interestingly, even though the GILTI provision applies to all U.S. shareholders of CFCs, irrespective of whether the shareholder is for example a C corporation, an S corporation or an individual, only domestic corporations are entitled to foreign tax credit. This presumably decreases the attractiveness of using a C corporation instead of an S corporation in the future.

[38] There are now in total five categories for CFC's gross income, i.e. the general category income, the passive category income, the GILTI, the foreign branch income, and the specified separate categories, e.g. treaty resourced income. See Section 904.

[39] However, this is not always the case in practice due to the calculation formulas being essentially based on aggregate amounts.

GILTI inclusion amount of a domestic corporation as the CFC's U.S. shareholder or with previously taxed earnings and profits are eligible to be deemed paid.

An interesting feature of the GILTI is that the taxation is carried out at the level of the U.S. shareholders, but the taxation of GILTI does not require the CFCs to actually distribute profits to their U.S. shareholders. It means that the taxation is not triggered at the moment of profit distribution and it may not be deferred. On the contrary, the amount of GILTI shall be included in the gross income of U.S. shareholders on a yearly basis. Thus, the taxation of GILTI follows the logic of the subpart F income of the CFCs, the taxation of which has been stipulated in Section 951.

3.2 Foreign Derived Intangible Income

Whereas the GILTI provision applies to all U.S. persons that are U.S. shareholders of CFCs, the FDII provision applies to all U.S. corporations. Pursuant to Section 250(a), a U.S. corporation is allowed to make a 37.5% deduction of the income treated as foreign derived intangible income (FDII). Taken into account the 21% CIT rate, the deduction means that income regarded as FDII is effectively taxed at the rate of 13.125%.

The FDII provision is applied to taxable years beginning after December 31, 2017.[40] Consequently, the FDII provision will be first applied in the taxation carried out in 2019. In addition, it is stipulated in Section 250(a)(3)(A) that, for taxable years beginning after 2025, the deduction shall be made at the rate of 21.875% instead of 37.5%. Thus, the effective tax rate applicable to FDII will be 16.406% as of 2025.

The definition of FDII and its calculation formula are stipulated in Section 250(b). According to the Section, FDII of a U.S. corporation is the amount bearing the same ratio to the deemed intangible income as the foreign derived deduction eligible income bears to the deduction eligible income. This is illustrated in the figure below:

[40] Conference Report 2017 p. 167.

$$\text{FOREIGN DERIVED INTANGIBLE INCOME (FDII)} = \text{DEEMED INTANGIBLE INCOME (DII)} * \frac{\text{FOREIGN DERIVED DEDUCTION ELIGIBLE INCOME (FDDEI)}}{\text{DEDUCTION ELIGIBLE INCOME (DEI)}}$$

Figure 3. *Foreign Derived Intangible Income.*

The definitions of the amounts of income used in the calculation of FDII have been defined in same Section 250(b). Firstly, pursuant to Section 250(b)(3), the deduction eligible income (DEI) refers to any excess of gross income over deductions, including taxes, allocable to such gross income. The gross income is taken into account without regard to certain categories of income that would skew the calculation. The categories to be excluded from the gross income of a corporation in the calculation of DEI are for example the amount of GILTI, dividend received from CFCs, and foreign branch income.[41]

The foreign derived deduction eligible income (FDDEI) is any deduction eligible income derived in connection with property, which is sold to a non-U.S. person and is for a foreign use, or services which are provided to any person or with respect to property not located within the U.S. The foreign use means any use, consumption, or disposition not within the U.S. The income derived from sale of property or provision of services to domestic intermediaries, i.e. non-related parties located within the U.S., is not treated as FDDEI even if the purchaser uses the property for a foreign use or the acquired services in providing services that are treated as FDDEI.

Related party transactions are examined more strictly and not treated in principle as for a foreign use, unless specific requirements are met. Pursuant to Section 250(b)(5)(D), related party means any member of an affiliated group as defined in Section 1504(a).[42] In addition,

[41] The entire list of categories to be deducted from gross income for the purpose of calculating the DEI pursuant to Section 250(b)(3)(A)(i) is as follows: any amount included in the gross income under Section 951(a)(1); the GILTI included in the gross income under Section 951A; any financial services income as defined in Section 904(d)(2)(D); any dividend received from a CFC of such domestic corporation; any domestic oil and gas extraction income; and any foreign branch income as defined in Section 904(d)(2)(J).

[42] Pursuant to Section 1504(a), affiliate groups are chains of includible corporations connected through stock ownership with a common parent corporation, where the common parent owns directly stock meeting the 80-percent voting and value test as stipulated in Section 1504(a)(2) in at least one of the other includible

any person other than a corporation shall be treated as a member of such group if such person is controlled by members of such group or controls any such member.[43] Thus, a sale of property to a related non-U.S. party is not for a foreign use unless such property is ultimately sold by the related party, or used by the related party in connection with property which is sold or the provision of services, to another person who is an unrelated non-U.S. party and such property is for a foreign use. A service provided to a related non-U.S. party is treated as for a foreign use only if the taxpayer can show that the service is not substantially similar to services provided by such related party to persons located within the U.S.

Finally, pursuant to Section 250(b)(2), the deemed intangible income (DII) refers to the excess of deduction eligible income defined above over the deemed tangible income return of the corporation. The deemed tangible income return follows the formula used for calculating the amount of GILTI, and is thus 10% of the corporation's qualified business asset investment as defined in relation to GILTI Section 951A(d). That is, the same definition of QBAI as well as the same amount of deemed 10 % return on the QBAI are applied in the calculation of both GILTI and FDII.

The Proposed FDII Regulations provide an anti-avoidance rule in Section 1.250(b)-2(h), pursuant to which certain transfers are disregarded when calculating DII and QBAI for the purposes of the FDII of a domestic corporation. The transfer shall be disregarded if a domestic corporation, with a principal purpose of decreasing the amount of its DII, transfers specified tangible property to a specified related party of the corporation and, within the disqualified period, the corporation or an FDII-eligible related party of the corporation leases the same or substantially similar property from any specified related party. In this case, the corporation is treated as owning the transferred property solely for purposes of determining the QBAI. The same applies to so called structured arrangements, i.e. arrangements where the other party is not a related party, if the reduction in the corporation's deemed tangible income return is a material factor in the pricing of the arrangement with the transferee or if based on all the facts and circumstances, the reduction in the domestic corporation's deemed

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corporations, and stock meeting the same requirements set out in Section 1504(a)(2) in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations. It should be noted that the 80-percent threshold is significant, and thus the meaning of related party in this context is more restricted than for example the definition typically used e.g. in transfer pricing context.

[43] Pursuant to Section 954(d)(3), control means the ownership of stock possessing more than 50% of the total voting power or the ownership of more than 50% by value of the beneficial interests, depending on the legal form of the person subject to control.

tangible income return is a principal purpose of the arrangement. However, it is explicitly stated in the Proposed FDII Regulations that the anti-avoidance rule does not apply to transfers to and leases from with unrelated parties.[44]

Based on the above, the amount of FDII is the share of all deemed intangible income corresponding to the ratio of foreign-derived deduction eligible income to the corporation's overall deduction eligible income. However, this calculation method does not take into consideration the real source of the excess of deemed tangible income return. Nor does it acknowledge whether all income regarded as FDII are actually obtained abroad and actually derived from intangibles.

3.3 Impact on Taxation of Intangible Income

The purpose of the FDII provision is clearly to encourage the export of intangible-related goods and services. This is achieved by providing a right to deduction and thus a lower effective tax rate applicable to foreign-source intangible income of U.S. MNEs. Thus, the FDII provision forms an incentive for U.S. MNEs to have their intangibles to the U.S. instead of offshoring them.

The other side of the coin, the GILTI provision, in turn aims to discourage the offshoring of intangibles to low tax jurisdictions. According to the provision, U.S. shareholders shall include in gross income any income of their CFCs that exceeds the deemed routine return on tangible assets. The GILTI provision thus creates a new taxable income category for CFCs and effectively complements the taxation of CFCs. After the adoption of the GILTI provision, the only CFC income streams not subject to U.S. taxation are the NDTIR, as it does not form part of GILTI, and income qualifying for the high tax exception to subpart F under Section 954(b)(4).[45]

However, a deduction at the rate of 50% of the income treated as GILTI is allowed. In addition, U.S. shareholders are allowed to 80% foreign tax credit of taxes paid abroad, which are properly attributable to that income. Thus, GILTI is actually only taxed in the U.S. if the

[44] Proposed FDII Regulations p. 18.

[45] Before the introduction of the GILTI provision, U.S. tax on any income received by CFCs could be deferred provided that it did not fall into one of the subpart F categories. The traditional subpart F categories are the foreign base company sales income, foreign personal holding company income, and foreign base company services income. See Kroll et al. 2018 p. 33.

same income has been taxed abroad at a low rate. In principle, if GILTI has been effectively taxed in the CFC's resident country at least at the rate of 13.125%, no tax should be payable on the same income in the U.S.[46] This means that the GILTI provision in fact creates a worldwide backstop or minimum tax for certain income accrued by CFCs of U.S. shareholders.

It has been said that the GILTI and FDII provisions are meant to be scrutinized together, whereby their full impact can be analyzed. By providing certain incentives and creating other disincentives, together these provisions act as a carrot and a stick in the taxation of intangible-derived income. This is at least the intention of the provisions on paper. In addition, it has been pointed out that the provisions neutralize tax differences, because foreign-source intangible income is always taxed at the same rate, i.e. 13.125%, despite of whether the intangibles are located in the U.S. or abroad.[47] However, taking all factors into consideration, the provisions might involve also other implications. These real implications are analyzed more broadly and deeply from the point of view of U.S. MNEs in following Chapter 4.

As a final note, the aim and impact of GILTI and FDII provisions may also be examined in context of the tax reform. Internationally, the key impact of the TCJA was the shift from worldwide to territorial taxation by introducing the participation exemption. In this light, it is said that the GILTI and FDII provisions actually complement the participation exemption by diminishing the incentive to offshoring intangible assets, which are already in principle easily transferred. In addition, the GILTI provision actually acts contrary to the participation exemption by implementing a kind of worldwide minimum tax on foreign income deemed to be derived from intangibles.

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[46] However, this does not apply in all situations in practice because there are various factors affecting the calculation of the amount of GILTI and FTC, *inter alia* the allocation of interest expenses and the fact that the GILTI is calculated on an aggregate basis. See Viitala – Ahonen 2018 p. 11.

[47] Aldonas 2019 p. 876. However, interestingly this does not apply to domestic intangible income, which is taxed at the federal CIT rate of 21%.

4 Impact on U.S. MNEs

4.1 Incentives and Disincentives

In light of previous Chapter 3, the initial assumptions regarding incentives and disincentives of FDII and GILTI provisions are clear. First, with regard to the FDII regime, the effective tax rate of 13.125% applicable to FDII can be considered quite low compared to the statutory CIT rate of 21% in the U.S. as well as the average corporate tax rate of 23.7% in OECD countries.[48] Thus, the FDII regime clearly encourages U.S. MNEs to own intangibles and export goods and services related thereto.[49] Albeit depending of the applicable foreign tax rate, it is obvious that under many circumstances the FDII provision could constitute a real incentive for U.S. MNEs to shift their intangible profits to be taxed in the U.S. Second, the GILTI regime voids attempts by U.S. MNEs to shift intangibles offshore in the hope that income deriving from those assets would be taxed at a low or even zero rate. Together the provisions seem to encourage the developing and holding of intangibles in the U.S. and to disincentivize locating of intangibles in foreign jurisdictions.[50]

It has also been pointed out that, through a combined effect, the provisions ensure that the intangible income is always taxed at least at the rate of 13.125% regardless of whether the income is domestic-source or foreign-source. Thus, as mentioned above, the FDII and GILTI regimes together should in fact diminish any incentive to shift intangible investment and profits outside the U.S.[51] This would be in line with the overall purpose of the TCJA, which has been considered as a response to the OECD BEPS project. It implies that the provisions seem to effectively combat base erosion and profit shifting by discouraging excessive offshoring and attracting investments in the U.S.

However, despite the characterization of the GILTI provision as a “stick”, it also provides a significantly lower effective minimum tax rate compared to the domestic federal CIT rate of 21%. Due to the lower rate as well as narrow tax base, the GILTI provision has been considered to be too generous in order to have an actual impact on U.S. MNEs.[52]

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[48] OECD Corporate Tax Statistics 2019 p. 11.
[49] Viitala – Ahonen 2018 p. 11; Singh – Mathur 2018 p. 18–20.
[50] Mintz 2018 p. 22 and 28.
[51] Aldonas 2019 p. 876.
[52] Harris – Looney 2018 p. 14. Harris – Looney suggest that the GILTI provision would better meet its objective of disincentivizing foreign investments if the minimum tax rate was increased to 15%, tangible equity

Consequently, even though the purpose of the GILTI regime and its global minimum tax is to discourage the operations abroad, the offshoring of intangibles could still result in lower taxation in some cases.[53]

Furthermore, as the amount of GILTI is calculated on an aggregate basis, the U.S. MNEs can combine operations in higher tax countries and tax havens, and taxes paid in higher tax countries offset the minimum tax otherwise due on income obtained in tax havens. This has been considered to effectively incentivize the offshoring instead of repatriating.[54] On the other hand, the effective tax rate provided under the FDII provision is not especially low compared to certain patent box regimes, as we will see in Chapter 5.2.2.

Consequently, it is uncertain whether the original objectives of GILTI and FDII provisions are actually met. Various commentators have concluded that the provisions might not really have a huge influence on the U.S. MNEs' tax planning or that they may even work in contrary to their objectives by incentivizing offshoring of assets and preserving profit shifting.[55] The GILTI and FDII provisions are even said to create substantial distortions to the ownership of assets both in the U.S. and abroad.[56]

As an interesting remark, the impact of the GILTI and FDII regimes does not limit to intangibles and income derived from intangibles. Due to the calculation methods applied in determining the amount of GILTI and FDII, the regimes are also expected to have significant impact on the location of *tangible* investments. This is because the calculation formulas do not take into consideration where the income really derives from. With regard to both GILTI and FDII, the calculation is based on the deemed 10% return on QBAI, and the exceeding amount is deemed to be derived from intangibles. Thus, it follows that the location of tangible assets, amount of income derived from such assets, as well as overall amount of domestic versus foreign income affect the final amount of FDII and GILTI.

With regard to the GILTI, the provision could actually encourage profit shifting and offshoring of tangible assets in order to increase the amount of income exempted from

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allowance was reduced from 10 percent to the rate applied to risk-free investments, and calculations were made on a country-by-country basis.

[53] Kroll et al. 2018 p. 38; Singh – Mathur 2018 p. 21–22. However, U.S. MNEs would also have to consider any other aspects such as transfer pricing consequences and other transaction costs, which might neutralize small differences.

[54] Clausing 2018 p. 19 and 27.

[55] For example Harris – Looney 2018 p. 14; Kysar 2018 p. 3.

[56] Dharmapala 2018 p. 1.

GILTI. On the other hand, the same incentives exist for the FDII regime, too: a decrease in domestic tangible assets of a corporation expectedly increases the share of foreign derived income and thus the exceeding share deemed to be derived from intangibles. Hence, U.S. MNEs could exploit these computational rules by offshoring tangible assets and onshoring intangible assets.[57]

This has been recognized by the Congressional Budget Office (CBO), which has explicitly stated that the GILTI and FDII provisions could together increase the incentive for U.S. MNEs to make tangible investments abroad. This would benefit U.S. MNEs under both provisions.[58] Consequently, these provisions, the original aim of which was to encourage holding of intangibles in the U.S., could actually have an adverse impact with regard to the location choices related to tangible assets. It remains to be seen to which extent the U.S. MNEs will benefit from this possibility. However, it must be noted that a massive exploitation of offshoring tangible assets by U.S. MNEs would certainly increase the pressure to repeal the GILTI exemption as being harmful to the US economy.[59]

The location choice of tangible investments has also a close relation with the location of workforce. It has been considered that, as a consequence of incentivizing U.S. MNEs to make tangible investments abroad, there could be outbound job migration.[60] Indeed, the GILTI regime combined with the participation exemption can be seen to encourage U.S. MNEs to carry out activities related to tangible assets, such as manufacturing in factories, abroad in their CFCs.

The GILTI and FDII regimes may likewise lead to exploitation of certain import and export patterns in order to benefit from a lower tax rate. For example importing and re-exporting of goods could possibly qualify for the lower effective tax rate provided by the FDII regime even if no significant modification took place in the U.S.[61] Furthermore, based on the Conference Report, it is clear that at least the exporting of goods, modifying them, and consequently importing them back to the U.S. does qualify for the application of lower tax

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[57] Fensby 2018 p. 991. See also illustrative examples, Kysar 2018 p. 4–12 and 15. However, it must also be pointed out that there are other factors apart from the GILTI and FDII regimes that affect the location choice of intangibles. For example, new expensing rules were introduced as part of the TCJA, pursuant to which certain tangible investments made in the U.S. between 2018 and 2022 qualify for 100% expensing.
[58] CBO 2018 p. 109–110.
[59] Avi-Yonah 2018b p. 5.
[60] Avi-Yonah 2018a p. 6.
[61] Avi-Yonah – Vallespinos 2018 p. 6.

rate.[62] The exploitation of these patterns, that maybe would not be carried out had there not been any tax incentive for that, is hardly a desirable outcome in the long run. Ultimately, the GILTI and FDII regimes provide U.S. MNEs with possibilities to benefit from lower tax rates compared to other U.S. corporations which do not operate abroad. This could encourage domestic U.S. corporations to offshore part of their business.

The area and type of business as well as the location choice affect the final impact of the GILTI regime. Depending on the CFCs, the impact may be greater or smaller. The more QBAI the CFC has, the more income is exempted from GILTI, resulting effectively in lower amount of GILTI. This clearly favors U.S. shareholders of CFCs whose business relies heavily on tangible assets. On the contrary, CFCs operating as holding or financing companies or for example in the high tech industry, where most of the assets consist of intangibles, have hard time avoiding the impact of GILTI. Additionally, taxes paid for the income abroad entitle to foreign tax credit and thus determine whether the exceeding amount of income treated as GILTI is ultimately taxed in U.S. As it has been stated above, if the GILTI has been effectively taxed at the rate if 13.125%, the foreign tax credit should in principle be sufficient to avoid any additional taxation on the same income in the U.S.[63]

Yet another interesting aspect that can be assumed to affect U.S. MNEs and their willingness to rely on the FDII and GILTI regimes are the uncertainties relating to their permanence. The GILTI and FDII provisions were enacted for an undetermined period of time. However, they could be amended or repealed at any time depending on domestic political situation and fiscal needs. In addition, foreign countries have raised questions as to whether the FDII regime in fact complies with international tax and trade policies especially in light of the commitments made in the OECD and WTO. These doubts will be discussed in more detail from Europe’s point of view in following Chapter 5. However, it can be stated here that consequently U.S. MNEs might be reluctant to make investment and other decisions solely based on the GILTI and FDII regimes, in case the regimes end up being repealed afterwards.

In conclusion, the FDII and GILTI provisions will together inevitably have a significant impact on all U.S. MNEs exploiting intangibles and carrying out activities abroad. This concerns especially new business fields, where the income is typically derived from innovations, patents, software, and other intangibles. On the other hand, the provisions affect

[62] Conference Report 2017 p. 625.
[63] 16.406% as of year 2025.

also U.S. MNEs conducting traditional business relying on factories and manufacturing. In light of the above, for example investment location decisions of new factories may have significantly different results under the GILTI and FDII regimes, depending on whether the investment is made onshore or offshore.

In addition, it is considered that the tax reform benefits U.S. MNEs whose business models are dispersed and based on local ownership of intangibles. On the other hand, U.S. MNEs whose business models are based on broad, global distribution of work and centralized ownership of intangibles might suffer from the tax reform. Despite the existing business model, any U.S MNE would anyway have to reassess their operations in light of the TCJA.[64] The corporations are thus recommended to pay due consideration to the impact of these provisions and possible restructuring needs.

4.2 A Few Consequences Observed So Far

As only one year has passed after the enactment of the FDII and GILTI provisions, there are not yet many real consequences to be observed. However, during the year representatives of many U.S. MNEs have already presented their preliminary views on the real impact of the provisions, and some effects can also be deducted from the financial documentation and other reports filed by U.S. MNEs.

First, it has been pointed out that the implementation of the GILTI regime does actually seem to result in a worldwide tax regime with a lower rate on foreign income. This is because many U.S. MNEs do not apparently have enough tangible investments offshore, so that they could benefit from the exemption corresponding to 10% deemed return on tangible assets.[65] Thus, the implementation of the GILTI provision has created a new, wide category of income subject to tax in the U.S., and it can definitely encourage offshoring of activities relating to tangible assets in the long run.

With regard to the FDII regime, based on the statistics it seems that there has not been a consistent and massive movement of offshore intangibles being transferred into the U.S. at least not yet. Pursuant to OFII's Quarterly Reports of Foreign Direct Investment (FDI) in the U.S., during Q1/2018 the FDI amounted to USD 63.7 billion, thereby not substantially

[64] Viitala – Ahonen 2018 p. 13.
[65] Avi-Yonah 2018b p. 4–5.

deviating from the previous quarters. This was followed by a negative quarter, resulting in a divestment of USD 0.8 billion in Q2/2018. However, during Q3/2018 the FDI went up to USD 116.3 billion according to the preliminary report.[66]

In this context, it should be noted that the presented figures are only suggestive towards the real impact of the FDII provision. The tariff policies and other trade actions from the Trump Administration have also assumedly affected the figures in great length. On the other hand, there are also signs that the FDII regime has been exploited to some extent. Based on the published SEC 100-K forms by U.S. MNEs regarding year 2018, it seems that many corporations were able to benefit from reductions under the FDII provision in their overall tax rates.[67] Despite this, it seems that the expectations towards the FDII regime have not fully fulfilled at least for now.

The modest exploitation of FDII regime probably has to do with uncertainties relating to the permanency of such regime. Apart from uncertainties deriving from the domestic political situation, it is also uncertain whether the FDII regime constitutes a harmful tax regime or a prohibited export subsidy and is thus contrary to international commitments in the OECD and the WTO. The legitimacy of the FDII provision under the tax and trade policies is examined in more detail in Chapter 5.2.

In addition, a decision to shift intangibles into the U.S. would be relatively permanent and difficult to overturn: it would be challenging or at least very expensive to transfer intangibles assets yet again offshore if the FDII regime is later amended or repealed.[68] Due to the recent amendments to Sections 367 and 482, the definition of intangibles applied in the U.S. taxation has been broadened significantly. This combined with the realistic alternative principle means that, in transfers of intangibles, their overall value is often estimated to be higher than before.

The observations discussed above seem to follow original estimations. In a bigger picture, the CBO has estimated in their Budget and Economic Outlook for years 2018 to 2028 that the reduction of corporations' incentives to shift profits by transferring intangibles outside the U.S. is expected to remain modest. The overall estimate is that the tax reform will altogether reduce profit shifting by USD 65 billion per year, on average, over the next 11

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[66] OFII 2018.
[67] Foster 2019.
[68] Avi-Yonah 2018b p. 5–6.

years. However, this amount seems small compared to the total amount of profit shifting, which is still estimated to remain at the level of roughly USD 300 billion per year.[69] In addition, it is noted that most of the intangibles currently located offshore are expected to remain there. This is because tax havens continue to have relatively low tax rates. However, for newly created or future intangibles, the TCJA may deter a small amount of profit shifting.[70]

It remains to be seen whether these predictions hold true. In addition, it should be noted that the estimates presented above do not take into account several factors external to the tax reform. These include the uncertainties of investors relating to the stability of the FDII regime and the legislation in general as well as the tax competition from other countries. Thus, it may be that the eventual impact of the TCJA, and consequently also the FDII and GILTI regimes, on profit shifting is even smaller than expected.[71]

[69] CBO 2018 p. 124.
[70] CBO 2018 p. 125.
[71] Kysar 2018 p. 18.

5 Implications for Europe

5.1 Preliminary Implications and Reactions

Since the final implications of the GILTI and FDII regimes are still somewhat uncertain, it is also unclear how they will impact the European countries. However, at a general level one could assume that the adverse impacts of the provisions in the U.S. market discussed above could in principle have positive impact in the European market and *vice versa.* For Europe and other foreign countries, the central issue is whether the GILTI and FDII regimes are composed of cooperative or competitive elements in light of international taxation.[72]

Consequently, to the extent the GILTI and FDII regimes incentivize U.S. MNEs to shift their intangibles into the U.S., Europe would assumedly suffer from decreased revenues and R&D. The FDII regime and possible shift of assets overseas thus creates a threat of losing revenue and jobs in Europe. This is the central threat the EU and other foreign countries have focused on ever since the enactment of the TCJA. On the other hand, if the regimes incentivize U.S. MNEs to make tangible investments abroad, for example in Europe, Europe would naturally benefit from that in form of increased revenue and job migration.[73] As mentioned above, it may well be that the regimes ultimately incentivize U.S. MNEs to make tangible investments, and in some cases also intangible investments, in Europe and elsewhere outside the U.S.

The GILTI regime has been considered a strong cooperative element, as it might encourage foreign countries to maintain their corporate taxes at the minimum rate of 13.125% and the U.S. MNEs to accept such corporate tax burdens.[74] Thus, its impact does not limit to being a stick that encourages U.S. MNEs to locate their intangibles in the U.S. On the contrary, offshoring might still be a reasonable alternative for many U.S. MNEs in light of the participation exemption and relatively low effective tax rate.[75] Having said that, the GILTI provision might not even affect CFCs operating in Europe if their local effective tax rate exceeds the threshold of 13.125%. However, as we will see in Chapter 5.2.2, many EU Member States provide a so called dual rate structure, where the income derived from patents

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[72] *Morse* has discussed competitive and cooperative global tax policy strategies pursued by states at a general level and reviewed the TCJA in this regard, see Morse 2018.
[73] Avi-Yonah 2018a p. 20.
[74] Morse 2018 p. 376–378.
[75] Avi-Yonah – Vallespinos 2018 p. 5.

and other similar assets may be taxed at a considerably lower tax rate compared to the normal CIT rate.

On the other hand, as the amount of GILTI is calculated on an aggregate basis and not per company or per country, the activities carried out and taxed in Europe cannot be examined separately from MNEs' other offshore activities. This has been argued to increase the protection for foreign jurisdictions' CIT rates.[76] However, the other side of the coin is that is also encourages to carry out some operations in tax havens in order to offset the final tax burden. This makes it very difficult to draw simple conclusions. The overall global structure, locations, and tax planning of U.S. MNEs ultimately affect how much of the income accrued in Europe is subject to GILTI tax in the U.S.

The above is only a plain simplification of the impacts in the U.S. and Europe and does not take into consideration other relevant market areas such as Asia. Hence, the ultimate implications of the regimes remain to be seen. In addition, proceedings at the international level for example in the OECD and the WTO may affect the application of the GILTI and FDII regimes in the future, should the FDII regime be considered a harmful tax regime or an illegal export subsidy. However, at a general level, the TCJA is expected to be very favorable to U.S. MNEs because it significantly decreased corporations' overall tax burden.[77] This overall impact may encourage the U.S. MNEs to increasingly consider domestic investments and focus more on their domestic field in the future.

From the beginning, the EU has had doubts about the TCJA and especially the FDII regime. These doubts were brought in light for the first time already prior to the TCJA's enactment, when five EU finance ministers sent a letter in early December 2017 to Secretary of the Treasury Mr. Mnuchin.[78] Later on, the EU requested the OECD Forum on Harmful Tax Practices (FHTP) to take a closer look of the FDII regime.[79] At the moment, the issue is still pending in the FHTP and no final decision had been made. On the other hand, the FDII regime has not been challenged in WTO for now, but it might because of the pending

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[76] Morse 2018 p. 378.

[77] It is expected that, due to lower CIT rate, the GILTI and FDII provisions, and other amendments, U.S. MNEs end up paying less tax on both domestic and foreign activities under the new tax regime. See Harris – Looney 2018 p. 13.

[78] Letter to Mnuchin 2017. The letter was signed by Peter Altmaier, Federal Minister of Finance in Germany; Bruno Le Maire, Ministery of Economy and Finance in France; Philip Hammond, Chancellor of the Exchequer in the U.K.; Pier Carlo Padoan, Minister of Economy and Finance in Italy; and Cristóbal Montoro Romero, Minister of Finance and Civil Service in Spain.

[79] The initiative came from the High Lever Working Party on Tax Questions, see Johnston 2018 p. 590.

proceeding in the OECD. Both of these issues will be analyzed in more detail in following Chapter 5.2.

As there are also negative impacts from European point of view, the implementation of the TCJA and especially the FDII regime could encourage European countries to take countermeasures and thus increase tax competition. First, the impact of GILTI and FDII provision can be assessed in light of overall corporate taxation in the U.S. and the EU. This might create a pressure for the European countries to lower their applicable CIT rates, especially taking into consideration that the U.S. significantly lowered its federal CIT rate from 35% to 21% by enacting the TCJA. However, the pressure is not expected to be very significant in this regard, as the U.S. did not begin a race to the bottom. On the contrary, by lowering their CIT rate the U.S. is now well in line with the average CIT rate of 23.7 % among the OECD countries.[80] However, some countries where the CIT rate is significantly higher, such as Japan, Australia, Germany and France, could be expected to lower their CIT rates in the future.[81]

In addition or instead of lowering the CIT rate, which would work as a carrot, the European countries could also consider introducing a countermeasure that would work as a stick, and try to protect their domestic tax base by imposing duties on import. Moreover, European countries could introduce CFC rules that would efficiently target European MNEs investing in the U.S. through their subsidiaries. This could be done by taxing the profit generated by the subsidiaries at the level of the European parent, if the U.S. tax rate applied to the income of the subsidiaries is low enough.[82] Another alternative would be to impose a global minimum tax by following the mechanism of GILTI provision. This measure could be taken either unilaterally or in international cooperation. As a matter of fact, the OECD has recently presented a proposal regarding global minimum tax that greatly resembles the GILTI provision. This will be discussed in more detail in Chapter 5.3.

Finally, albeit it would seem a very radical countermeasure at first sight, the EU could also include the U.S. on the list of noncooperative tax jurisdictions if the EU considers that the U.S. has not fulfilled its duties under the OECD BEPS Project. The list currently consists of

[80] OECD Corporate Tax Statistics 2019 p. 11. The corporate tax rate of 21% in the U.S. is a federal tax; with state and local taxes, the total tax rate is in average 24 to 26%. See Viitala – Ahonen 2018 p. 7.
[81] Viitala – Ahonen 2018 p. 7. For now, there have not been any significant reductions in the CIT rates of these countries.
[82] Avi-Yonah 2018a p. 9.

countries that are regarded as tax havens.[83] Including the U.S. in that list would thus definitely shed a bad light on the country.

In conclusion, it will be interesting to see to what extent EU Member States and other foreign countries will react to the TCJA and bring tax competition to another level. In can be expected that the type and extension of potential countermeasures significantly depends on how the FDII is ultimately characterized in international context. Thus, next the FDII regime is analyzed in more depth in light of the international obligations imposed by the OECD and the WTO.

5.2 FDII under International Scrutiny

5.2.1 Tax Policy Perspective: Harmful Tax Practice?

The OECD aims to restrain harmful tax competition by setting limits to and scrutinizing preferential tax regimes unilaterally enacted by countries. The issue was addressed already in 1998, when the OECD published the report titled Harmful Tax Competition: An Emerging Global Issue (HTC Report). The criteria that was originally listed in the report for examining preferential tax regimes is still applied in the assessment. In addition, the criteria has been added recently based on the results and conclusions achieved in the OECD's BEPS Project, under BEPS Action 5.

The aim of BEPS Action 5 was to counter harmful tax practices more effectively, taking into account transparency and substance, and it continued to develop the work of the Forum on Harmful Tax Practices (FHTP). The examination of intangible-related preferential tax regimes was conducted separately from other regimes, which underlines their specific features.[84] Furthermore, the BEPS Action 5 was selected as one of the four BEPS minimum

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[83] Johnston 2018 p. 592. The list was recently updated, and as of March 26, 2019, the list is composed of the following countries: American Samoa, Aruba, Barbados, Belize, Bermuda, Dominica, Fiji, Guam, Marshall Islands, Oman, Samoa, Trinidad and Tobago, United Arab Emirates, U.S. Virgin Islands, and Vanuatu. See more detailed explanation regarding each country in Council conclusions on the revised EU list of non-cooperative jurisdictions for tax purposes 2019/C 114/02.

[84] BEPS Action 5 p. 9 and 23. See also Tables 6.1 and 6.2 p. 63–64, where the IP and non-IP regimes have been separated.

standards, i.e. subject to the monitoring process and peer review, which highlights its importance in the field of international taxation.[85]

Under the Action, it was agreed that the substantial activity requirement would be approached by means of the so called nexus approach[86], which refers to the benefits being conditional on the research and development (R&D) activities carried out by taxpayers receiving benefits.[87] As the nexus approach requires a link between the income receiving benefits and the expenditure contributing to that income, its ultimate objective is to ensure that IP income may not be shifted into a preferential jurisdiction without transferring also the underlying R&D activity to create that IP.[88]

In addition, the assets eligible for preferential tax regimes have been limited. The only IP assets qualified for tax benefits under an IP regime are patents and other IP assets that are functionally equivalent to patents. This means that the assets need to be legally protected and subject to similar approval and registration processes, if relevant.[89] The outcome of BEPS Action 5 together with the HTC Report set clear limits, albeit with a certain degree of discretion, to the preferential tax regimes provided by countries and thus control harmful tax competition.

With regard to the FDII regime, after being over a year in force, it is still under peer review conducted by the FHTP. The assessment was on hold until the long-waited Proposed FDII Regulations were finally released on March 4, 2019,[90] and a final decision has not yet been adopted to date.[91] If the FDII regime were found to be a harmful export subsidy, there would not necessarily be any direct consequences, as the OECD does not have enforcement powers. However, it is considered that the U.S. has a lot at stake here because the U.S. depends now more on its foreign trading partners than ever before. In addition, the world's largest trading

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[85] Other minimum standards and subject to peer review are BEPS Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances); Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting); and Action 14 (Making Dispute Resolution Mechanisms More Effective).
[86] The other alternatives were the value creation approach and the transfer pricing approach, which did not get a lot of support. See BEPS Action 5 p. 24.
[87] BEPS Action 5 p. 24.
[88] BEPS Action 5 p. 24 and 29.
[89] BEPS Action 5 p. 26.
[90] Sarfo 2019 p. 905.
[91] This study was submitted to review on April 12, 2019.

partners are joining forces to prevent harmful trade and tax practices for example in the OECD, the EU, and the WTO.[92]

Indeed, five EU Finance Ministers expressed their concern on the FDII regime being not compatible with the BEPS consensus already prior to the enactment of the TCJA. In the letter, the finance ministers expressed their concerns on possible distortions in the international tax consensus and trade and investment environment, and addressed issues especially with regard to the contemplated excise tax, base erosion and anti-abuse tax (BEAT), as well as the GILTI and FDII regimes.

As regards the latter, it was explicitly mentioned that the FDII regime could be challenged as an illegal export subsidy because it provides a deduction for income derived from intangible assets other than patents and copyright software. Furthermore, it was mentioned that the FDII regime deviates from the agreed nexus approach by providing benefits to intangible income without due consideration to research and development (R&D) activities.[93] Later on when the FDII regime had already been enacted, Pierre Moscovici, Tax Commissioner at the European Commission, affirmed the concerns that the FDII regime may be contrary to the OECD BEPS Action 5 modified nexus approach for intellectual property regimes.[94]

Several commentators have also considered that the FDII regime inevitably constitutes a harmful tax regime by not fulfilling even one of the two criteria added by the BEPS Action 5, the nexus approach and the applicability to patents and similar assets only.[95] This seems obvious: the FDII regime does indeed contain no requirements whatsoever relating to the R&D nor where the income benefiting the lower effective tax rate is actually derived from. The calculation of the amount of FDII is solely based on deemed foreign derived, intangible-generated income. On the other hand, its scope and intention still makes it a regime targeted at IP-derived income.

On the other hand, the U.S. officials have in turn consistently assured that the FDII regime is compliant with the OECD regulation on preferential tax practices.[96] In this regard, the

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[92] Willis 2019 p. 1482.
[93] Letter to Mnuchin 2017 p. 3.
[94] Moscovici 2018.
[95] For example Willis 2019 and Fensby 2018.
[96] For example by Jason Yen, Attorney-Advisor in the Office of Tax Policy, U.S. Treasury, in a panel discussion in January 2018, see Sledz 2018; and Lafayette G. Harter III, Treasury deputy assistant secretary for international tax affairs in a conference in February 2018 and October 2018, see Johnston 2018 p. 590.

U.S. strongly relies on the consideration that the FDII provision is not even meant to be a preferential tax regime but a balancing element alongside the participation exemption and the GILTI regime. The U.S. has emphasized that the GILTI and FDII provisions should be examined together. Only this way their overall impact, i.e. neutralization of tax consequences regardless of whether foreign intangible-related investments are made through a CFC or directly by a domestic corporation, can be acknowledged.

Thus, the FDII provision is said to act as a mirror with the GILTI provision and add tax neutrality in response to base erosion and profit shifting, which the participation exemption and the GILTI provision could together create.[97] Consequently, according to the U.S. the FDII provision should not be regarded as a regime equivalent to for example European patent boxes at all, as its purpose is not to incentivize intangibles but to provide for tax neutrality between domestic and foreign situations. This purpose of neutralizing and minimizing any tax considerations between the alternatives to operate in foreign markets directly or through a CFC has also been explicitly mentioned in the recently released Proposed FDII Regulations.[98]

In addition, a few other issues which could prevent the classification of the FDII regime as a harmful tax regime have been presented in legal literature. First, it has been argued that, due to the large scope of the FDII provision, it is not actually an IP regime. For example going concern value and goodwill are hardly categorized as typical IP assets and thus there would not be a nexus requirement to be met. In addition, the criteria for tax regimes is rather ambiguous, as the countries adopt different sets of rules and use different techniques in creating patent box regimes, and also the classification of R&D expenditures especially with regard to sundry expenditures is finally up to the companies.[99]

However, opposite views have also been presented. Possibly the strongest counterargument is that there is no mandatory connection between the FDII and GILTI provisions. On the contrary, the regimes are separate and distinct and can be applied separately to taxpayers, meaning that U.S. MNEs may benefit from the FDII regime without having any CFCs and

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[97] For example Scanlon, Attorney-Adviser of the Treasury Office of International Tax Counsel in February 2019, see Foster 2019; Yen, Attorney-Adviser of the Treasury's Office for Tax Policy in January 2018, see Fensby 2018 p. 991; and Harter, Treasury deputy assistant secretary for international tax affairs in February and October 2018, see Johnston 2018 p. 590.
[98] Proposed FDII Regulations p. 58.
[99] Sanchirico 2018 p. 13–14.

thus being affected by the participation exemption and the GILTI regime.[100] In this light, it is difficult to see that the favoring arguments based on the necessary connection between the regimes and mirror effect would eventually hold water.

In addition, it has been remarked that the FDII provision does not seem to be tax neutral either, as it does not apply to domestic intangible income. Thus, it does make a clear distinction between domestic and foreign income derived from intangibles, the first being taxed at the rate of 21% and the second at the rate of 13.125%. Finally, it has been pointed out that even apart from the new criteria set out in BEPS Action 5, the FDII provision also seems to violate the no substantial activities criterion set out in the HTC Report, since it also encourages to have few tangible assets.[101]

It has been doubted that the final decision by the FHTP has not yet been given because of the central role of the FDII provision as part of the tax reform. Considering the specific nature of the provision, it is not easily amended to comply with the criteria set out by the OECD. The inclusion of the nexus approach to the FDII regime afterwards or its limitation to apply only to patents and patent-like IP assets afterwards seems impossible due to its tight connection with the GILTI regime and the exotic, all-inclusive approach of the provision.[102] However, it has been suggested that the U.S. could remove the foreign use requirement and modify the FDII regulation to be applied also in domestic sales. This would make the provision more legitimate in light of international requirements, as the FDII regime would no longer incentivize foreign business only.[103]

Although the decision by the FHTP cannot be enforced, the decision could have significant indirect impact in organizations like WTO, where binding rulings can be given.[104] In addition, avoiding the opening of the "political Pandora's Box" and not granting a final decision would likewise have a terrible end, as it would seriously detract the credibility of the FHTP review process.[105] It remains to be seen which position the FHTP will finally adopt as regards the FDII regime.

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[100] Willis 2019 p. 1482–1483.
[101] Fensby 2018 p. 991.
[102] Fensby 2018 p. 990.
[103] Willis 2019 p. 1484.
[104] Johnston 2018 p. 592.
[105] Fensby 2018 p. 989.

5.2.2 Comparison between FDII and European Patent Box Regimes

Due to the aforementioned discussions at the level of the OECD and the incentives that the FDII provision provides, it is interesting to take a closer look at the provision and compare it with its equivalent regimes in Europe. Indeed, the FDII provision has been considered by the commentators as "the American version to the "patent box" –like regimes.[106] This is natural because all these regimes seem to have the same objective, i.e. to encourage corporate taxpayers to shift their intangibles under certain jurisdiction and to discourage the outsourcing of the same intangibles.

In this section, the FDII regime is compared with certain patent box regimes provided by various European countries. The selected regimes for conducting this short comparative analysis are the ones provided by Ireland, Luxembourg, the Netherlands, and the UK. These regimes have been selected because they have all seem quite attractive from the point of view of investors and MNEs operating in Europe. In addition, all these regimes have been declared not harmful in the OECD 2018 Progress Report on Preferential Regimes, i.e. they are seen to comply with the preferential tax regime rules described above.[107] The regimes in Ireland and Luxembourg are new and were designed in compliance with the new standards.[108] On the other hand, the regimes in the Netherlands and the UK are older and were recently amended in light of new requirements resulting from BEPS Action 5.[109]

The regime offered by Ireland is called Knowledge Development Box. The regime provides relief from corporation tax on income derived from patents, computer programmes and, for smaller companies, also from certain other certified IP, which are together referred to as qualifying assets. If a company qualifies for the regime, it is entitled to a deduction of up to 50% of its qualifying profits. This means that the qualifying profits may be taxed at the effective tax rate of 6.25%. The qualification requires that the company create a usable qualifying asset from R&D activities that earns income.

The IP regime offered by Luxembourg allows the qualifying IP assets to benefit from an 80% exemption from income taxes, thereby resulting in an effective tax rate of

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106 Avi-Yonah 2018a p. 7; Johnston 2018 p. 589.

107 "Not harmful" means that the regime is in scope but does not have any features which implicate any of the criteria, see OECD Progress Report on Preferential Regimes 2018 p. 17.

108 OECD Progress Report on Preferential Regimes 2018 p. 21.

109 OECD Progress Report on Preferential Regimes 2018 p. 18–19.

approximately 5%. Eligible assets under the IP regime are inventions protected under patents, utility models, and other IP rights equivalent to patents, as well as software protected by copyright. On the other hand, market-related IP is not eligible. In order to be eligible, it is required that the assets are resulting from R&D activities carried out by the taxpayer itself, either in Luxembourg or through a foreign permanent establishment located in the European Economic Area which does not benefit from similar IP regime.

The IP regime provided by the Netherlands is called Innovation Box regime. The regime was originally introduced in 2007 and it offers an effective tax benefit on profit derived from innovation. Under the regime, profit is effectively taxed at the rate of 7% instead of the regular 25% corporate income tax rate. The regime may be applied if at least 30 % of the profits have been originated by the patent. Like in Luxembourg, also in the Netherlands the software capable of being protected by copyright may be eligible for the application of the regime. On the other hand, market-related material such as logos and brands are not eligible. In order to be eligible, the company must have been granted an R&D certificate.

Lastly, the United Kingdom provides a Patent Box regime, which was first introduced in 2013. Under the Patent Box regime, a lower tax rate of 10% is applied instead of the normal corporation tax, currently at the rate of 19%. The regime may be entered into if the company holds qualifying IP right, most typically a patent. In addition, the taxpayer is required to have undertaken qualifying development on the patents.

From the above it can be derived that all these allowed regimes are at least in principle strictly limited. The regimes contain a detailed definition of income eligible under the preferential regime and other requirements for applying the regime. The regimes are strictly limited to patents and patent-like assets only, and the taxpayers are required to conduct R&D activities in order to benefit from the regime. Thus, benefit provided by these regimes is clearly more strictly regulated than the one provided by the FDII regime, which operates on assumptions, takes into consideration all of the taxpayer’s income, and does not pay any attention to R&D activities. These clear distinctions between the FDII regime, which is still under scrutiny, and the European patent box systems, which have been declared not harmful, may indicate the FDII regime is indeed in danger of being regarded as a harmful tax regime.

On the other hand, all European patent box regimes examined here provide for even lower effective tax rate than the FDII regime. The effective tax rates are 6.25%, 5%, 7%, and 10%, respectively, compared to the rate of 13.125% provided by the FDII regime. This raises a

question whether the European patent box regimes are adverse tax competition as well even though they formally fulfil the requirements for a preferential tax regime. This view has been adopted in legal literature, and the broad negative impact of patent box regimes causing base erosion and profit shifting has been pointed out.[110] It has even been suggested that the whole patent box concept should be delegitimized.[111] Reaching such a political decision in consensus could however take years. In the meantime, it is for the FHTP and the countries to evaluate where the line between allowable patent regimes and illegal preferential regimes is drawn.

5.2.3 Trade Policy Perspective: Illegal Export Subsidy?

Another powerful measure that the European or other counties could take against the U.S. would be to file a formal complaint against the FDII regime in the WTO. Unlike the OECD and the FHTP, which only provide recommendations, the WTO could give a binding ruling on the FDII regime. The possibility of a WTO challenge as regards the FDII regime has been debated ever since the regime was drafted. As with doubts concerning harmful tax practice, the threat of a WTO challenge was mentioned for the first time already in the letter by the five EU Finance Ministers to Secretary Mnuchin in December 2017, prior to the enactment of the TCJA. The Finance Ministers stated that the FDII regime could constitute an illegal export subsidy under the WTO SCM Agreement rules.[112]

The discussion around a WTO challenge has continued ever since the introduction of the FDII provision. For example Pierre Moscovici, Tax Commissioner at the European Commission, pointed this out in his answer to parliamentary questions on March 22, 2018.[113] In addition, several commentators have raised the question whether the FDII regime constitutes an illegal export subsidy, and many of them have adopted the view that it well might.[114]

However, a formal complaint has not yet been filed with the WTO even though the FDII provision has been in force for more than a year now. According to speculations, this might

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[110] Beller 2028 p. 22–23.
[111] Fensby 2018 p. 992.
[112] Letter to Mnuchin 2017 p. 3.
[113] Moscovici 2018.
[114] See for example Avi-Yonah 2018a p. 7 and 21; Viitala – Ahonen 2018 p. 13; Avi-Yonah – Vallespinos 2018; Harris – Looney 2018 p. 14.

be because the FDII regime is still under scrutiny by the FHTP in the OECD, and the pending process would enable the EU to engage in discovery before filing a WTO complaint.[115] It remains to be seen whether a complaint is filed in the WTO and how the final outcome by the FHTP – either positive or negative – might affect to the decision to file a WTO complaint.

If the FDII regime was challenged in the WTO, it would be examined under the Agreement on Subsidies and Countervailing Measures. This is because the FDII regime could be seen to violate Article III(2) of the General Agreement on Tariffs and Trade (GATT) as a discriminatory internal tax, i.e. a tax that is imposed on importers but not on domestic sellers. However, it must first be noted that the SCM Agreement applies to goods only. Consequently, the examination of the FDII regime would limit to goods, and any possible subsidy the regime provides with regard to provision of services may not be examined under the SCM Agreement. This has been considered to significantly reduce the exposure of the FDII regime to a WTO complaint.[116]

Pursuant to Article 1.1(a)(1)(ii) of the SCM Agreement, a subsidy means *inter alia* a financial contribution by a government where government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits), and a benefit is thereby conferred. There seems to be a wide consensus, even among commentators who might not otherwise think that the FDII regime constitutes an *illegal* subsidy, that the FDII regime does fulfill the definition of a subsidy under the SCM Agreement. This is because under the FDII regime the corporate income is effectively taxed at the rate of 13.125% compared to the statutory CIT rate of 21%.[117]

On the other hand, the characterization of the FDII regime as a subsidy has also been questioned by doubting whether there is actually government revenue that would be otherwise due and not collected or foregone due to the application of the FDII provision. The key justification for this argument lies on the comparison of the FDII regime with other specific provisions providing tax benefits, i.e. the participation exemption regime, the GILTI regime, and the CFC rules, instead of the statutory CIT rate. Hence, if the FDII regime was repealed, the taxpayers would arguably be able to enjoy from even lower effective tax rate

[115] Aldonas 2019 p. 874–875.
[116] Aldonas 2019 p. 881. According to Aldonas, if a taxpayer sells hardware as well as software and services, any alleged subsidy would be narrowed to the amount corresponding to the export of goods alone.
[117] See for example Aldonas 2019 p. 882; Avi-Yonah – Vallespinos 2018 p. 5–6.

by resorting to other means.[118] Albeit this is an interesting point of view, it does not fully answer to the question whether tax benefits under certain regime can be justified by referring to other tax benefits only and why taxation under the FDII regime could not be compared to the taxation of general corporate income or even domestic intangible derived income, and thus to the statutory CIT rate of 21%.

Assuming that the FDII regime constitutes a subsidy, it would constitute a breach of the WTO rules only if it was found to be prohibited or actionable. Most of the debate by the commentators has focused on whether the FDII regime constitutes a prohibited export subsidy. Pursuant to Article 3.1 of the SCM Agreement, prohibited subsidies category includes subsidies that are contingent, in law or in fact, upon export performance; and subsidies that are contingent, upon the use of domestic over imported goods.[119] The prohibition means, under Article 3.2 of the SCM Agreement, that no Member shall neither grant nor maintain such subsidies. Any Member country may refer the matter of a suspected prohibited or actionable subsidy to the Dispute Settlement Body to be ruled upon if prior consultations do not result in a mutually agreed solution.

The key to whether the FDII regime is a prohibited subsidy, i.e. contingent in law or in fact upon export performance, seems to lie in whether there indeed exists *contingency* upon *export*. It has been pointed out that the FDII regime effectively provides for a lower tax rate of 13.125% on intangible income derived from serving foreign markets compared to other income, which is taxed at the normal CIT rate of 21 %. Moreover, the first mentioned rate applies to foreign intangible income whereas the latter applies to domestic intangible income. Thus, it is stated that the FDII provision clearly provides for a lower rate to certain sales of goods by U.S. MNEs to any foreign person for a foreign use. This has been seen to constitute a prohibited subsidy, as it is clearly contingent in law and in fact upon export performance.[120]

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[118] Sanchirico 2018 p. 10–12.
[119] With regard to a subsidy being contingent *in law* or *in fact*, for the latter it has been separately stated in the corresponding footnote in the SCM Agreement that the standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. In addition, it is mentioned that the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy. Annex I of the SCM Agreement contains an illustrative list of export subsidies.
[120] Avi-Yonah – Vallespinos 2018 p. 6; Harris – Looney 2018 p. 14.

On the other hand, other views have also been adopted. It has been considered that the FDII regime would not constitute a prohibited subsidy on the *de jure,* in law, basis. This is because the FDII provision does not mention export, export earnings, or export performance. In addition, the FDII provision does not refer to goods but property, which means many things apart from traditional goods, such as IP rights, confidential business information, and customer lists, and these items could possibly not be subject to the SCM Agreement due to its limitation to goods.[121]

In addition, it has been argued that the FDII regime would not constitute a prohibited subsidy on the *de facto,* in fact, basis either. This view has been based on the notions that the FDII regime would not actually oblige the taxpayer to export goods as a condition for qualifying for the deduction, that the FDII regime is not in fact tied to actual or anticipated exports, and that the FDII regime does not operate in a way that any benefit provided by the regime was offered in anticipation or expectation of exports. The FDII regime is effectively distanced from the term export by pointing out that the sale of property to a person who is not a U.S. person for a foreign use, i.e. the definition of the foreign derived deduction eligible income, does not limit to the mere export of goods.

Based on the aforementioned, it has been concluded that even if export might benefit from the FDII regime, this is not alone sufficient to treat the FDII regime as a prohibited subsidy.[122] This view could however be debated, as the real impact of the FDII regime, its original aim, and even the mention of "foreign derived" in the name of the regime implies that the FDII regime is effectively connected to the export by U.S. taxpayers.

5.2.4 History of American Export Subsidies and the WTO

Although the outcome of a possible WTO challenge or whether the FDII provision is even challenged is uncertain, it can be mentioned that former attempts by the U.S. to enact a provision providing tax relief for U.S. taxpayers on foreign derived income have not ended well under the rules of the WTO and its predecessor, the GATT. It all began with the domestic international sales corporation (DISC) rules, which the U.S. enacted in 1971. The

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[121] Aldonas 2019 p. 883–884.
[122] Aldonas 2019 p. 884–885. Aldonas has examined the FDII regime in great detail in light of the Appellate Body Report, Canada – Measures Affecting the Export of Civilian Aircraft, 1999, where the Appellate Body outlined on the interpretation of a *de facto* export contingency.

DISC provisions enabled indefinite deferral of tax on export derived income by treating the income attributed to the DISC as it if was earned abroad and exempt from subpart F. In 1976, the DISC provisions were found to violate the GATT rules.

The DISC provisions were replaced by the foreign sales corporation (FSC) rules in 1984. Under the FSC rules, U.S. taxpayers could form a foreign entity, typically in a low tax jurisdiction, to perform specific functions relating to export sales. As the U.S. taxpayers could also benefit from deferral, the FSC rules effectively allowed taxpayers to avoid tax on a share of their foreign source income. The FSC provisions were challenged under the new binding dispute settlement, the WTO Dispute Settlement Understanding, which was introduced in late 1990s and made rulings binding unless all WTO Members rejected. This ended up being one of the largest trade disputes between the European Community and the U.S., and finally resulted in a victory for Europe, when the FSC provisions were considered to constitute an illegal export subsidy.

Quickly followed by the ruling on the FSC provisions, the U.S. introduced yet another set of rules, the so called Extraterritorial Income (ETI) regime in 2000. The ETI provisions inverted the preceding FSC provisions: instead of allowing the U.S. taxpayers to exclude part of their foreign source income from their gross income, the gross income definition was modified to exclude the export income. The ETI regime was likewise considered violation of the WTO rules in 2004. Consequently, the ETI rules were repealed in 2004 and replaced by the domestic manufacturing provision. It did not violate the SCM Agreement because it was not contingent on export performance. The domestic manufacturing provision, former Section 199, was however repealed when the TCJA was enacted.

The FDII regime and a possible challenge in the WTO have also been analyzed in the light of the history explained above.[123] It goes without saying that the negative decisions on previous provisions relating to taxation of export profits raise a doubt of whether the FDII regime follows this path. Some commentators have considered that the similarity between the FDII regime and its predecessors indicates clearly that the FDII regime would be contrary to the WTO rules, too.[124]

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[123] For more detailed information regarding the DISC, FSC, and ETI regimes in light of GATT/WTO rules, see for example in Avi-Yonah – Vallespinos 2018 p. 6–8; Aldonas 2019 p. 872–874.
[124] Avi-Yonah – Vallespinos 2018 p. 6–8.

In support of this argument, it has been pointed out that the two central arguments invoked by the U.S. in previous challenges could no longer be used. These arguments are the rebalancing argument and the double tax argument. With regard to the rebalancing argument, it essentially relates to the principle of worldwide taxation which prevailed prior to the tax reform. However, the TCJA and especially the participation exemption introduced a shift from the worldwide taxation towards territoriality, and thus it seems that there is no longer an unbalance that would need to be redressed. In addition, the FDII regime can neither be used to correct unbalance caused by alleged discriminatory border tax adjustments, as the FDII provision is a deduction allowed in income taxation and not part of indirect taxation.[125]

It could however be argued that the territoriality and its extent may *de facto* be questioned even in light of the TCJA. As mentioned earlier, especially the GILTI provision does not follow the principle of territoriality. On the contrary, it imposes a worldwide minimum tax on certain foreign source income, and the FDII provision is said to mirror that.[126] Hence, it may be that the rebalancing argument would still hold true at least to some extent.

In addition, the double tax argument is likewise considered not applicable with regard to the FDII regime. Pursuant to Annex I of the SCM Agreement, the countries are allowed to take measures in order to avoid double taxation of foreign source income. The export of goods and services is however typically not taxed in a foreign country under the general principles of international tax law and permanent establishment provisions included in tax treaties.[127] Consequently, it has been considered that the FDII regime is even more likely to be challenged and even more likely to fail a WTO challenge than its predecessors.[128]

On the other hand, opposite views have also been presented, according to which there is a significant disparity between the FDII regime and its predecessors, and that due to these key differences the FDII regime would not in fact constitute an illegal export subsidy. First, it has been pointed out that all former disputes have derived from the fact that direct and indirect taxes are treated differently under the GATT. This is because, under the GATT rules, indirect taxes could be rebated upon the export of goods but the rebate of direct taxes on income forms an actionable export subsidy.[129] Furthermore, it is argued that unlike the

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[125] Avi-Yonah – Vallespinos 2018 p. 8–9.
[126] Fensby 2018 p. 989.
[127] Avi-Yonah 2018a p. 9–10.
[128] Avi-Yonah 2018a p. 6 and 10.
[129] Aldonas 2019 p. 871–872.

predecessors, which were results in trade policy, the FDII regime essentially constitutes a tax measure necessary in the combat against profit shifting.[130]

If the FDII regime is ultimately considered a prohibited subsidy, it remains to be seen how the situation is solved. Unlike previous export subsidies, the FDII regime is tightly connected to both the GILTI provision and the whole tax system. Thus, it cannot be simply amended or repealed without paying due attention to its overall impact, and the repeal of FDII provision would most likely require substantial changes also in other regards. This also raises a question of whether the European countries would rather rely on countervailing measures.[131]

5.3 GILTI as Model for Global Minimum Tax

Although the U.S. has faced a lot of criticism on the TCJA from the EU, the tax reform also involved many improvements in international tax law and supported the combat against base erosion and profit shifting. One of the key amendments in this regard was the GILTI provision, which introduced an innovative mechanism to ensure minimum tax on certain foreign intangible income. This new approach is special because the provision in fact allows minimum taxation of income without interfering with the tax sovereignty of foreign jurisdictions.

Consequently, the GILTI regime, including the foreign tax credit equivalent to 80% of the taxes paid abroad, may induce U.S. MNEs to pay more local taxes in the local jurisdictions of their CFCs and thus increase their effective tax rate. As discussed in Chapter 5.1, the GILTI provision has many cooperative elements in light of international taxation. Several scholars have argued that the GILTI regime actually encourages subsidiaries of U.S. MNEs located in Europe and elsewhere to pay a decent amount of local taxes and discourages zero tax planning. Second, it also encourages foreign countries to maintain relatively high CIT rates, improves their attractiveness compared to low or zero tax jurisdictions and even induces the rise of foreign tax rates.[132] Finally, the GILTI provision may also lower the incentive for European countries to engage in tax competition.[133]

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[130] Aldonas 2019 p. 886.
[131] Ballan 2018 p. 15.
[132] Singh – Mathur 2018 p. 2; Avi-Yonah 2018a p. 12; Morse 2018 p. 377–378.
[133] Singh – Mathur 2018 p. 11.

In legal literature, the GILTI provision has been referred to as a unilateral cooperative measure in the combat against base erosion and profit shifting. It has been argued that cooperation does not always have to mean multilateral actions. On the contrary, unilateral measures with cooperative solutions may promote the objective in the beginning and provide a basis for consequent cooperative strategies.[134] The view has been supported by referring to the Foreign Account Tax Compliance Act (FATCA), which was originally a unilateral measure taken by the U.S. but ultimately turned into collective, multilateral exchange of information, when other countries followed the example.[135] In addition, when a country with sufficient market power like the U.S. has imposed minimum tax on certain income, other countries have the cover to follow the lead and may take similar measures, too.[136]

The GILTI provision has also influenced the discussion around taxation of digitalized economy, which has lately been subject to intense debate both in the EU and the OECD. Originally, the topic on digital tax arose out of multiple cases where large MNEs – typically U.S. based – were able to avoid paying almost all taxes as a result of aggressive tax planning. The relation between the GILTI regime and digital tax proposals is interesting and it has even been considered that the GILTI regime has already partially solved the problem by implementing a minimum tax on offshore intangible income accrued by U.S. MNEs.[137]

However, even though the GILTI provision prevents U.S. MNEs from enjoying zero or low tax liability on certain foreign source income, it does not distinguish income derived from exploitation of IPR, other intangibles, and tangibles at a more specific level. Nor are the European counties allowed to tax on digital or other income accrued by U.S. MNEs in European markets under the GILTI provision. In addition, the GILTI provision only applies to U.S. based MNEs and thus does not solve the problems were profit shifting is conducted by MNEs based in Europe and elsewhere. Thus, it is unlikely that the GILTI provision alone is a sufficient measure to avoid base erosion and profit shifting in the long run.

There are already signs of other countries being interested in adopting similar measures, either unilaterally or at a global level. Recently the OECD published a public consultation document on addressing tax challenges of the digitalization of the economy, which continued the work initiated in the OECD BEPS Project. The document provided stakeholders with

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[134] Beller 2018 p. 35–36.
[135] Beller 2018 p. 27.
[136] Beller 2018 p. 39.
[137] Nieminen 2019.

several proposals to be commented and analyzed prior to the public consultation on the tax challenges of digitalization held in Paris on March 13 and 14, 2019. One of the proposals, the income inclusion rule, bears a clear resemblance to the mechanism of the GILTI provision, and this influence has also been explicitly stated in the document.[138]

The income inclusion rule is presented as one of the two inter-related rules under the global anti-base erosion proposal.[139] The global anti-base erosion proposal aims to provide a comprehensive solution to profit shifting and ensure that all internationally operating MNEs pay a minimum level of tax on their profits. The proposal would apply to all kind of income, but it is explicitly mentioned that the greatest risk of profit shifting relates to intangible profits. The proposal would not affect the tax sovereignty of each jurisdiction to set their own tax rates. Instead, it would reinforce tax sovereignty of all countries to "tax back" profits that have not been sufficiently taxed by other countries under their tax sovereignty.[140] The proposal is suggested to be implemented by amending domestic law and double tax treaties.[141]

Under the income inclusion rule, a shareholder in a corporation would be required to bring into account certain share of the income of that corporation if the income was not subject to tax at a minimum rate. According to the proposal, the requirement would only apply to shareholders that owned a significant ownership interest in the company, for example 25%. The amount of income would be calculated under domestic rules and shareholders would be entitled to claim a credit for any tax paid on the attributed income. Overall, the income inclusion rule would supplement each country's CFC rules.[142]

The income inclusion rule closely resembles the GILTI provision but there are also some differences. Perhaps the most notable difference is that, according to the proposal, no income would be carved out. Thus, the income inclusion rule would apply to all profits regardless of whether the income derives from exploitation of tangible or intangible assets. On the other hand, the GILTI provision provides a minimum tax on deemed intangible income only and

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[138] OECD Tax Challenges of the Digitalisation of the Economy 2019 p. 26, section 98.
[139] The other proposed rule is tax on base eroding payments, which would in turn consist of two elements: undertaxed payments rule and subject to tax rule. Under these rules, it would be possible to deny a deduction or treaty relief for certain payments that have not been taxed at a sufficient level in the other state. See OECD Tax Challenges of the Digitalisation of the Economy 2019 p. 25 and 27.
[140] OECD Tax Challenges of the Digitalisation of the Economy 2019 p. 24.
[141] OECD Tax Challenges of the Digitalisation of the Economy 2019 p. 25.
[142] OECD Tax Challenges of the Digitalisation of the Economy 2019 p. 25.

does not apply on deemed routine return on tangible assets. In addition, there might be deviation in the minimum level of ownership or control required in order to apply the income inclusion rule. According to the OECD proposal, the threshold could be for example 25%, whereas the GILTI provision is applied to all U.S. shareholders that own at least 10% of a CFC.

The proposal regarding income inclusion rule is still preliminary and several key issues, such as the minimum tax rate and minimum threshold for ownership, remain to be discussed. Despite the common ground and similar mechanisms, it might be that the final proposal on income inclusion rule deviates even more of the original GILTI provision. The idea is not flawless and has its own challenges. However, it might be warmly welcomed by OECD countries because it could fix some of the challenges that have surged in transfer pricing and application of arm's length principle and simplify international taxation in that regard. In addition, the overwhelming approach of the income inclusion rule would presumably be more impartial among countries and thus resolve some of the problems relating to the proposal of digital tax, which would impact some countries harder than others. It will be interesting to see in which direction the international taxation evolves and whether the income inclusion rule or other innovative approaches are ultimately adopted.

6 Conclusions

This study has focused on the preliminary implications of the GILTI and FDII provisions and central doubts relating thereto. As the TCJA was enacted only less than one and a half years ago, final implications are still to be seen. However, at this point it can already be recognized that the regimes have significantly affected the taxation of intangible income at a global level and raised issues every U.S. MNE needs to take into consideration. Furthermore, they have stimulated debates on whether international trade and tax policy commitments made in the WTO and the OECD have been breached and provided inspiration for future development of international taxation.

The mechanism the FDII and GILTI regimes are based on is innovative: instead of trying to define what could be characterized as intangibles and trying to determine the exact income derived from them, the calculation methods are purely based on assumption of routine return on tangible assets. Although the calculation formulas are complicated, at least the taxpayers are not obliged to recognize their intangibles, provide reports relating to intangibles, and explain how their intangibles are related to the accrued income. Depending on the final outcome in pending international proceedings, this novel approach may also inspire and be adopted by other countries in the future.

On the other hand, this same innovative nature of the regimes has caused uncertainty in the international field. The protectionist features of the FDII regime have raised questions whether the regime in fact constitutes a harmful tax regime or a prohibited export subsidy. There are no similar adoptions by other countries at least not yet and the FDII regime clearly deviates from what has been traditionally thought of when the tax and trade policy boundaries have been set. Even though at first look the FDII regime does not seem to comply with the policies, it is difficult to say whether the regime ultimately constitutes a breach.

In addition, it is an interesting remark that the influence of the FDII and GILTI provision does not limit to intangible assets only. On the contrary, it might be that the impact is even greater on the location of future tangible investments. This is because making tangible investments abroad seems to benefit U.S. MNEs under both provisions. In addition, the MNEs may also prefer to carry out tax planning in relation with tangible assets rather than intangible assets because transfer pricing risks relating to tangible assets are lower.

In addition, it should be noted that the transfer pricing provisions relating to intangible assets have been tightened both in the U.S. and the OECD. Consequently, it can be expected that the transfer of intangibles often results in high value to be compensated, when the assets are increasingly regarded as a whole. This makes outbound transfers of intangibles challenging for U.S. MNEs in the future.[143]

These factors can be expected to reduce willingness of U.S. MNEs to repatriate intangibles for the sole purpose of obtaining tax benefits. At the same time, in many cases there are no longer huge differences in effective taxation of intangible income between different countries. The equalization is due to several reasons such as increased tax competition, implementation of GILTI, and global limitations on tax incentives that may be provided at a domestic level. Consequently, despite the ever growing role of intangibles in business, it might well be that, in the future, the location of intangibles is no longer a key question in the tax planning of U.S. MNEs.

At a more general level, the FDII and GILTI regimes have raised a lot of discussion on where the boundaries between acceptable and unacceptable tax competition measures lie and how the problem of base erosion and profit shifting should be addressed in the future. Tax competition is harmful for every state in the long run, which is why there have been serious intents to limit and control it. Perhaps the OECD BEPS Project is the best example of this so far. However, the discussion on tax competition has not yet reached an end, it has rather barely begun. MNEs operate increasingly at a global level and use more and more intangibles in value creation, which cannot always be easily located. This presents challenges for international tax law and requires cross-border cooperation between states.

The future is uncertain, and the future of taxation is always dependent on political changes and current fiscal needs. The TCJA was an initiative carried out entirely by the Republicans. However, as for the current 116th U.S. Congress, the House is controlled by the Democrats and the Senate by the GOP. The new composition combined with observed initial implications of the tax reform and international demands may cause pressure for the Congress to introduce amendments to the GILTI and FDII provisions and the overall tax regime. On the other hand, the innovative and comprehensive approach of the FDII and

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[143] Foster 2019.

GILTI regimes, close connection between them, and their central role in the tax reform make it challenging for the Congress to adjust the provisions.

From the point of view of international taxation, the post TCJA tax system in the U.S. is essentially based on the territoriality principle. However, it still contains certain features of the worldwide taxation principle, for example the GILTI regime. In case amendments are made, they could change the current balance and develop the overall tax system in either direction. The GILTI provision may be fully repealed, which would dramatically decrease the worldwide taxation of US MNEs. On the other hand, the GILTI rate could be increased to 21%, i.e. to correspond with the general CIT rate, in which case there would be full parity from tax point of view between onshore and offshore income of U.S. MNEs.[144]

To conclude, the FDII and GILTI provisions have raised a lot of issues to be discussed in the field of international taxation. The international pressure to amend or repeal the FDII provision presumably continues still for a long time. On the other hand, the GILTI provision and its innovative approach have inspired discussion on the possibility of a global minimum tax. At a more general level, there is underlying pressure to adapt international tax rules and to match them better with the modern world, where many of the MNEs' operations are cross-border or digital. This is a challenge for tax sovereignty and requires cooperation among the countries. Ultimately, it seems that the FDII and GILTI regimes are just a new chapter in this discussion, and the debate on cooperation in international taxation as well as acceptable and unacceptable tax competition will continue also in the future.

[144] Avi-Yonah 2018b p. 5.