KPMG

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Senate Finance Committee chairman, Democratic members: Discussion draft on overhauling U.S. international taxation

Senate Finance Committee Chairman Ron Wyden (D-OR) and Democratic members of the committee Senators Sherrod Brown (D-OH) and Mark Warner (D-VA) today released draft legislation that proposes changes to the U.S. international tax system.

Read the **draft legislation** [PDF 76 KB] and a **section-by-section summary** [PDF 500 KB].

Comments on the draft are requested to be sent to InternationalTax@finance.senate.gov by September 3, 2021.

The trio previously unveiled a framework—***Overhauling International Taxation***—[PDF 676 KB] in April 2021. Read ***TaxNewsFlash***

The draft legislation unveiled today contains the following proposals:

- Reform the global intangible low-taxed income (GILTI) system by repealing the exemption for the 10% deemed return on qualified business asset investment (QBAI) owned abroad, and functionally approximating a country-by-country system for GILTI through a mandatory high-tax exclusion system.

  KPMG observation: A move to a mandatory high-tax exclusion system could amplify timing differences in the recognition of income and foreign taxes for U.S. and foreign tax purposes. The draft legislation includes a placeholder to address such timing differences.

- Similarly modify subpart F and foreign branch rules to align with the new GILTI rules by applying a mandatory high-tax exclusion system determined on a country-by-country basis. While the effective exclusion for high-tax subpart F and GILTI would operate through the mechanism of the section 245A dividends received deduction, high-tax foreign branch income earned by a U.S. taxpayer would be explicitly exempt from tax.

KPMG observation: It is also notable that the treatment of CFC losses has been modified so that foreign taxes paid by a tested loss CFC may be considered if there is aggregate net tested income when the tested loss is aggregated with the positive tested income of a tested income CFC in the same country.

KPMG observation: Unlike the Biden Administration's proposal, the draft legislation does not contain an overall expense disallowance rule for income that is exempt or partially exempt under GILTI or subpart F. However, by explicitly excluding high-tax foreign branch income from gross income, section 265 would appear to deny deductions associated with expenses allocable to high-tax foreign branch income.

- Potentially extend the "haircut" that currently applies under section 960(d) to reduce foreign tax credits for tested foreign income taxes by 20% to (a) taxes imposed on distributions of previously taxed earnings and profits (PTEP) attributable to GILTI inclusions, (b) taxes properly allocable to subpart F income and distributions of PTEP attributable to subpart F inclusions, and/or (c) taxes allocable to foreign branch income. The precise scope of these modifications, and the magnitude of the haircut—including whether it would be uniform across different classes of income, are left uncertain.

KPMG observation: If the haircut is extended to both subpart F inclusions and foreign branch income, it would appear that the only foreign taxes not subject to a haircut would likely be withholding taxes on items such as interest, dividends and royalties (i.e., FDAP income).

KPMG observation: An extension of the haircut to subpart F inclusions and/or foreign branch income can be viewed as different in kind from the current law application to GILTI foreign taxes, where section 250 results in only partial U.S. taxation of GILTI income. In light of Congress's historical commitment to eliminating double taxation of foreign income (both through the Code and tax treaties) to extend the haircut outside of the context of a partial exclusion from U.S. tax would constitute a significant change in policy.

- Reduce and equalize (at an unspecified percentage) the section 250 deduction for GILTI and FDII. Following the previous framework, foreign-derived innovation income would replace "foreign-derived intangible income" as the amount qualifying for the section 250 deduction along with GILTI, substituting "deemed intangible income" with "domestic innovation income." Domestic innovation income is defined as the lesser of (1) the corporation's deduction eligible income (DEI) and (2) the sum of portion of its qualified research expenditures and its qualified training expenditures. To qualify, the expenditures must be for activities conducted in the United States. The draft legislation also provides new rules for determining qualified training expenditures. Notably, however, the foreign-derived innovation income calculation would continue to incorporate without change the use of the "foreign-derived ratio" (foreign-derived deduction eligible income/DEI) to determine the amount eligible for the section 250 deduction.

KPMG observation: The draft legislation generally anticipates prospective effective dates, for tax years beginning on or after the date of enactment. For section 250, however, the proposed effective date is unspecified. The transition to domestic innovation income could be favorable for some taxpayers that incur significant amounts of qualifying expenses but have little section 250 benefit under the current rules due to the amount of their domestic qualified business investment assets.

- Modify the allocation of research and experimental and stewardship expenses by treating such expenses as 100% allocated to U.S. source income for purposes of determining the foreign tax credit limitations if those activities are conducted in the United States.

- Reform the base erosion and anti-abuse tax (BEAT) system by adding a second bracket for base erosion income and providing full value to domestic business tax credits. Additionally, it is indicated that the drafters are "considering the best way to incorporate into the BEAT" the Biden Administration's SHIELD proposal (Stop Harmful Inversions and Ending Low-Tax Developments).

  KPMG observation: The draft changes to the BEAT are less clearly coordinated with the OECD's work on Pillar Two than the Biden Administration's SHIELD proposal is. Although the draft legislation anticipates that BEAT will incorporate elements of the SHIELD proposal, it does not currently clarify which elements of SHIELD may be adopted. The proposed GILTI amendments do not fully align with Pillar Two either, but similar to the Biden Administration's proposal, they do allow the GILTI rules to take into account taxes paid under an income inclusion rule at the ultimate foreign parent level.

Next steps

With the approval of the budget resolution by both the House and Senate, the relevant committees, including the Senate Finance Committee and the House Ways and Means Committee, may begin consideration of legislation for inclusion in a reconciliation bill at any time. It is possible that legislation based upon the discussion draft released today could be considered for inclusion in such legislation.