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A Hybrid Approach: The Treatment of Foreign Profits under the Tax Cuts and Jobs Act

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Key Findings

- The previous "worldwide" or residence-based corporate tax system was flawed as it encouraged corporations to "invert," discouraged corporations from repatriating foreign profits, and created a competitive disadvantage for U.S. corporations operating in foreign countries.
- Lawmakers addressed these issues by enacting reforms to the international tax system as part of the Tax Cuts and Jobs Act (TCJA).
- The TCJA enacted reforms that moved towards a territorial tax system by exempting foreign profits from domestic taxation. At the same time, it enacted anti-base erosion provisions targeted at high-return foreign profits, intangible income, and income stripped out of the United States.
- The four main components of the new international tax system are the participation exemption, the GILTI, the FDII, and the BEAT.
- While lawmakers generally refer to the new system as a "territorial" tax system, it is more appropriately described as a hybrid system.
- The general structure of the U.S. system is not unique in the Organisation for Economic Co-operation and Development (OECD) as most countries that have moved to territorial tax systems have also introduced anti-base erosion provisions. However, these U.S. provisions are structured differently from those of other countries.

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Introduction

Before the passage of the Tax Cuts and Jobs Act of 2017 (TCJA),[1] the United States had a residence-based, "worldwide" corporate tax system which taxed global earnings of U.S.-based companies (with a credit for taxes paid to foreign governments), but deferred the U.S. tax until the earnings were repatriated. The previous system created two primary distortions. First, it discouraged companies from repatriating foreign profits. Second, it encouraged companies to move their legal headquarters out of the United States through what are called "inversions."

Lawmakers addressed these issues by enacting reforms to the international tax system as part of the TCJA. The TCJA significantly changed the way in which the foreign profits of U.S.-based multinational corporations are taxed. It moved from what was considered a "worldwide" tax system towards a "territorial" tax system. At the same time, it enacted anti-base erosion provisions. These provisions are targeted at high-return foreign profits, intangible income, and income stripped out of the United States.

While lawmakers generally refer to the new system as a "territorial" tax system, it is more appropriately described as a hybrid system. The new system utilizes features from territorial (source), worldwide (residence), and destination-based corporate tax systems. In an international context, the U.S. system is not unique in that regard. Most Organisation for Economic Cooperation and Development (OECD) nations that have moved towards a territorial tax system have also introduced anti-base erosion provisions that move them away from what would be considered a "pure" territorial tax system.

Why Did Lawmakers Want to Reform the International Tax System?

Before the passage of the TCJA, the United States had a residence-based or "worldwide" corporate tax system. Under this system, U.S. multinational corporations were subject to U.S. income tax on their worldwide profits. U.S. profits were subject to the then 35 percent tax rate minus a credit for any foreign income taxes already paid on those profits.[2]

Corporations could defer the U.S. taxation of foreign profits as long as those profits were reinvested in ongoing foreign activities. However, under U.S. Subpart F, passive income (interest, dividends, rents, and royalties) was taxed on a current basis, meaning it did not get the benefit of deferral. This was to prevent companies from putting highly mobile financial assets abroad to indefinitely avoid U.S. tax liability on the income.

1 The law's official name is the "Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

2 Kyle Pomerleau and Kari Jahnsen, "Designing a Territorial Tax System: A Review of OECD Systems," Tax Foundation, August 1, 2017. https://taxfoundation.org/territorial-tax-system-oecd-review/

The previous residence-based system created two primary distortions. First, it discouraged companies from repatriating foreign profits.[3] This is because U.S. corporations only faced the additional U.S. tax on foreign profits when they repatriated those profits to the United States. Prior to the passage of the TCJA, it was estimated that companies had deferred tax on at least approximately $2.6 trillion in foreign profits kept abroad.[4]

Second, the previous system encouraged companies to move their legal headquarters out of the United States. Companies only potentially faced the additional domestic tax on foreign profits if they were resident in the United States. As such, companies could avoid the worldwide system by shifting their headquarters to another country. The companies would then still owe U.S. tax on profits earned in the United States, but would not owe U.S. tax on profits earned abroad. The U.S. worldwide system was one of the major drivers of corporate inversions over the last few decades.[5]

The United States' previous worldwide tax system was somewhat unique among developed nations. Prior to the passage of the TCJA, the United States was one of six nations that had a worldwide corporate tax system. Of the 35 OCED member nations, 29 had "participation exemptions," or territorial tax systems.[6] These systems vary significantly in detail, but generally under these systems, multinational corporations headquartered in these nations do not face an additional headquarter country tax on foreign profits when their foreign subsidiaries pay the profits to them in the form of dividends.

From the perspective of U.S. multinational corporations, the fact that most nations have a territorial tax system and the United States had a worldwide system could have created a competitive disadvantage (unless the firm had good uses for earnings kept abroad and could afford to leave the income in a deferred status). A U.S. multinational corporation operating in Germany would face the German corporate tax of 30 percent plus the additional 5 percent U.S. tax on German earnings repatriated to the United States. In contrast, a competing French firm operating in Germany would only face the German tax rate of 30 percent on its German income.

3 John R. Graham, Michelle Hanlon, and Terry J. Shevlin, "Barriers to Mobility: The Lockout Effect of U.S. Taxation of Worldwide Corporate Profits," *National Tax Journal* 63:4 (September 1, 2010): 1111-1144.

4 Letter to Chairman Kevin Brady and Richard Neal from the Joint Committee of Taxation, August 31, 2016. https://waysandmeans.house.gov/wp-content/uploads/2016/09/20160831-Barthold-Letter-to-BradyNeal.pdf

5 More than 50 companies have moved their headquarters abroad since 1981. See Zachary Mider, "Tax Inversion," Bloomberg, March 2, 2017. https://www.bloomberg.com/quicktake/tax-inversion

6 Pomerleau and Jahnsen, "Designing a Territorial Tax System: A Review of OECD Systems."

TCJA introduced a new tax system for U.S. multinational corporations

Recognizing the substantial shortcomings of the previous system for taxing the foreign profits of U.S. multinational corporations, lawmakers introduced reforms as part of the TCJA. These reforms significantly changed the way in which the foreign profits of U.S.-based multinational corporations are taxed.

The TCJA introduced four new major provisions.

The first provision is what is called a "participation exemption," which exempts foreign profits paid back to the United States from domestic taxation. This is what moved the U.S. system from a "worldwide" tax system closer to a "territorial" tax system.

The second and third provisions, "Global Intangible Low Tax Income" (GILTI) and "Foreign Derived Intangible Income" (FDII), are two newly-defined categories of income which are taxed at a lower rate than the statutory corporate tax rate of 21 percent. Together, they create a worldwide minimum tax on intangible income.

Lastly, the TCJA introduced a new minimum tax, "The Base Erosion and Anti-Abuse Tax" (BEAT), aimed at preventing multinationals from stripping income from the U.S. tax base with excess payments to foreign-affiliated corporations.

The Participation Exemption

The TCJA moved towards a "territorial" tax system by eliminating the additional U.S. tax on foreign profits through what is called a "participation exemption." Under the U.S. participation exemption, foreign profits paid to U.S. parent corporations in the form of dividends are fully deductible against taxable income.[7] The result is that these foreign profits do not face additional U.S. taxation as they did under previous law.

For corporations to qualify for the participation exemption on their foreign profits, they need to satisfy three general requirements. First, the U.S. corporation must own 10 percent of the vote or value of the controlled foreign corporation's (CFC) stock. Second, the U.S. parent corporation must satisfy a holding period requirement of 366 days. Lastly, the U.S. corporation cannot deduct a dividend against U.S. taxable income if that dividend received a tax benefit in a foreign country. Specifically, this is to prevent "hybrid dividends" that receive a deduction in the foreign country when paid to the U.S. and when received in the United States, resulting in effectively no tax on that flow of income.[8] The participation exemption excludes ordinary foreign profits paid to parent corporations in the form of dividends, but it does not exclude capital gains. U.S. companies that sell, or otherwise dispose of shares in CFCs, do not get an income exclusion on gains from those shares.

7 26 U.S. Code § 245A - Deduction for foreign source-portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations.

8 This is akin to the "qualified dividend" requirement for U.S. shareholders; for a corporate dividend to be "qualified" to receive a reduced tax rate, it must have been taxed at the corporate level first.

Global Intangible Low Tax Income (GILTI)

"Global Intangible Low Tax Income" (GILTI) is a newly-defined category of foreign income to be added to corporate taxable income each year.[9] In effect, it is a tax on earnings that exceed a 10 percent return on a company's invested foreign assets. GILTI is subject to a worldwide minimum tax of between 10.5 and 13.125 percent on an annual basis.[10] GILTI is supposed to reduce the incentive to shift corporate profits out of the United States by using intellectual property (IP).

Each year, U.S. multinationals must calculate their GILTI. GILTI is equal to what is called "net tested income" minus 10 percent of "Qualified Business Asset Investment" (QBAI). Net tested income is effectively all foreign profit earned by a U.S. parent firm's CFCs that has not been yet been taxed by the United States.[11] QBAI is equal to the value of all depreciable assets (machines, buildings, factories) that this U.S. parent's CFCs own.

Suppose a U.S. multinational corporation controls several CFCs that have a combined $1,000 of net tested income. The CFCs own $9,000 in QBAI. Income equal to 10 percent of the QBAI, or $900, is exempt from GILTI. The result is that this U.S. corporation's GILTI is equal to $100.

TABLE 1.

Example GILTI Calculation

Net Tested Income	$1,000
QBAI	$9,000
GILTI:	
Net Tested Income	$1,000
Minus	
QBAI Exemption (10% of QBAI)	$900
Equals	
GILTI	$100

In effect, GILTI is equal to foreign profits in excess of the "normal" returns to qualified investments.[12] The idea here is that in a competitive market, investments will yield what is considered an "ordinary" return, or a return sufficient enough to satisfy investors. In the case of GILTI, that return is assumed to be 10 percent. Any profits in excess of that ordinary 10 percent return are assumed to be connected to the returns to IP or profit shifting. For example, a coffee shop in France may ordinarily return investors 10 percent on an annual basis. However, this particular coffee shop owned by a U.S. corporation exploits intellectual property, such as brand power, which provides its coffee shop with a slight edge in the market. As a result, this shop returns investors a 15 percent return. The additional 5 percent return above the ordinary 10 percent return is assumed to be associated with either IP or profit shifting from another jurisdiction and captured in GILTI.

9 26 U.S. Code § 951A - Global Intangible Low-Taxed Income Included in Gross Income of United States shareholders.

10 However, as discussed later, U.S. multinational corporations may face rates on GILTI higher than 13.125 percent.

11 For example, some income may already have been taxed under Subpart F.

12 The definition of supernormal returns, or returns in excess of "normal" returns here is returns on investment in excess of 10 percent. It is likely that this is a too narrow definition of supernormal returns.

The law allows U.S. corporations to deduct 50 percent of GILTI.[13] The remainder is taxed at the statutory corporate rate of 21 percent. As a result, GILTI faces an effective tax rate of 10.5 percent.[14] U.S. corporations are also provided a foreign tax credit to offset foreign taxes already paid on GILTI. However, the foreign tax credit is limited to 80 percent of foreign taxes. This means for every dollar of foreign taxes paid, the U.S. corporation only received an 80-cent credit. In addition, excess foreign tax credits cannot be carried forward or back.

The purpose of limiting the foreign tax credit to 80 percent of foreign income taxes, rather than providing a full foreign tax credit, is to make U.S. companies more sensitive to their foreign income tax burdens. Under a full foreign tax credit, U.S. corporations are indifferent to their foreign income tax rate as long as their foreign income tax rate is below the U.S. rate. In contrast, under a limited foreign tax credit, U.S. firms face a higher total tax burden when their foreign tax liability is higher rather than lower, even if the foreign rate is still below the U.S. rate.

The 80 percent foreign tax credit results in a sliding scale of effective tax rates that vary with the foreign income tax rate. The worldwide GILTI rate is 10.5 percent when foreign income tax rates are zero and increases by 0.8 percent for each percentage point increase in the foreign effective tax rate. The effective tax rate on GILTI maxes out at 13.125 percent when the foreign income tax rate reaches 13.125 percent.

Return to the previous example of a U.S. corporation that had $100 of GILTI. This company would be allowed to deduct half of its GILTI against its taxable income. This would leave $50 in taxable GILTI. Applying the 21 percent statutory tax rate would result in an initial tax liability of $10.50. Suppose our sample corporation paid $5 in foreign tax on its $100 in GILTI. As such, the corporation would receive a $4 U.S. tax credit against its initial GILTI tax liability of $10.50. Overall, the U.S. company would pay $11.50 in tax on its GILTI ($5 to the foreign jurisdiction and $6.50 to the United States). The overall effective tax rate on GILTI would be 11.5 percent.

TABLE 2.

Table 2. Example GILTI Tax Calculation

GILTI	$100
Foreign Tax Liability on GILTI	$5
Foreign Tax Credit	$4
Initial U.S. Tax on GILTI	$10.50
Minus	
Foreign Tax Credit	$4
Equals	
Final U.S. Tax on GILTI	$6.50
Total Tax on GILTI	$11.50
Total Effective Tax Rate on GILTI	11.5%

13 26 U.S. Code § 250 - Foreign-derived intangible income and global intangible low-taxed income.

14 21% * 50% = 10.5%.

The GILTI minimum tax uses what is called a "one CFC" approach. As such, U.S. multinational corporations add up the total of all net tested income and QBAI across all CFCs throughout the world and face tax on their combined income. This is in contrast to a country-by-country minimum tax under which a U.S. corporation would calculate GILTI income for CFCs in each country. A one-CFC approach is more favorable to U.S. multinationals as it allows them to average their high- and low-taxed GILTI together and avoid tax on CFCs in certain low-tax jurisdictions. A country-by-country minimum would prevent this, but is much more complex to administer.

While the 80 percent limitation on the foreign tax credit implies that there should be no residual U.S. tax when the foreign income tax rate is higher than 13.125 percent, there are cases in which U.S. firms can face additional U.S. tax even with a foreign effective tax rate higher than that. This is because the foreign tax credit for GILTI is subject to the same limitations as the previous law foreign tax credit.[15] As such, certain expenses that U.S. multinationals incur in the U.S. can limit the value of the foreign tax credit to the extent they are allocated overseas.[16] Thus, corporations could be denied a portion of the foreign tax credit, and could face tax liability on GILTI even when their foreign tax rate exceeds 13.125 percent.

Foreign Derived Intangible Income (FDII)

The second newly-defined category of income is "Foreign Derived Intangible Income" (FDII). Like GILTI, FDII is income related to the use of intellectual property. However, FDII is income from the use of intellectual property in the United States in creating an export. FDII is provided a special lower tax rate of 13.125 percent. FDII is supposed to increase the incentive to companies to bring and keep intellectual property and the associated profits in the United States.

The definition of FDII is very similar to that of GILTI. FDII is equal to foreign-derived profits in excess of the "normal" returns to qualified investments. More specifically, FDII is equal to foreign-derived income minus 10 percent of "Qualified Business Asset Investment" (QBAI). Foreign-derived income is the share of a corporation's U.S. income related to the export of goods or services. QBAI for purposes of the FDII is equal to the value of tangible assets used in earning foreign-derived income. For example, a company may own a factory in the United States and export widgets to Germany. This company's foreign-derived income would be the income from the sale of those widget overseas, and the factory would be counted as QBAI for the purposes of FDII.

Companies are allowed to deduct 37.5 percent of their FDII against their taxable income. This brings the effective rate on each dollar of FDII to 13.125 percent.[17]

Suppose a company earned $10,000 in total income in the United States and 10 percent was earned by exporting goods overseas ($1,000). This company has $9,000 in QBAI related to its export activities. This implies that the company's FDII is $100: $1,000 in foreign derived income minus 10

15 The foreign tax credit is limited to total U.S. tax liability multiplied by the foreign taxable income divided by total worldwide taxable income. As such, to the extent expenses are allocated overseas, it reduces foreign taxable income and thus foreign tax credit.

16 Martin A. Sullivan, "Economic Analysis: More GILTI Than You Thought," *Tax Notes*, February 13, 2018. https://www.taxnotes.com/tax-reform/economic-analysis-more-gilti-you-thought

17 21% * (1 – 37.5%).

percent of QBAI ($900). This company would then be allowed to deduct 37.5 percent of its FDII ($37.50) against its taxable income. The result is taxable FDII of $62.50 and a tax liability of $13.125, an effective tax rate on FDII of 13.125 percent.

TABLE 3.

Example FDII Calculation

Total U.S. Income	$10,000
Export Share of Income	10%
QBAI	$9,000

FDII	
Foreign Derived Income	$1,000
Minus	
QBAI Exemption (10% of QBAI)	$900
Equals	
FDII	$100
Taxable FDII (FDII minus 37.5% deduction)	$62.5
FDII Liability	$13.125

The total deduction that a corporation can take for both GILTI and FDII is limited to corporate taxable income.[18] In other words, the combined deduction for GILTI and FDII cannot bring taxable income below zero. If the combined deduction would bring taxable income below zero, the deduction for FDII and GILTI would both be reduced in proportion to the point that a corporation's taxable income is zero.[19]

GILTI and FDII: A Worldwide Tax on Intangible Income

In combination, GILTI and FDII can be thought of as a worldwide tax on deemed intangible income.[20] They are meant to provide a backstop to the new participation exemption and reduce incentives for companies to move the location of intellectual property to shift corporate profits out of the United States.

Under the taxation of GILTI and FDII, U.S.-based multinational companies face roughly the same tax rate on intangibles used in serving foreign markets regardless of where those intangibles are located. If intellectual property is located in a foreign market and is used to sell products to foreign customers, it faces a minimum tax rate of between 10.5 percent and 13.125 percent through GILTI. If that same intellectual property is located in the United States and is used to sell products to those same foreign customers, it faces a tax rate of 13.125 percent through FDII.

18 26 U.S. Code § 250 - Foreign-derived intangible income and global intangible low-taxed income.

19 For example, suppose a corporation's taxable income is $100 before the deduction for GILTI and FDII. Also suppose its deduction for GILTI is $60 and $50 for FDII. This would initially reduce the corporation's taxable income to -$10. TCJA would first reduce FDII by $10 * $50/$110, or $4.50. Then the remaining excess ($5.50) would be subtracted from GILTI.

20 The definition of intangible income is the excess of 10 percent of qualified investments.

The idea behind a regime including FDII and GILTI is that they are a carrot and a stick that encourages companies to place profits and intellectual property in the United States.[21]

In this regard, FDII and GILTI are very similar to the international reform "Option C" proposed by former Chairman of the U.S. House Ways and Means Committee Dave Camp (R).[22] Using the same definition of intangibles (in excess of 10 percent of qualified investments), Option C placed a 15 percent minimum tax on intangible income located in foreign markets. At the same time, it provided a special 15 percent rate on intangibles located in the United States and used to sell products to foreign markets.

The Base Erosion and Anti-Abuse Tax (BEAT)

The final component of the new international tax system is a new tax called the "Base Erosion and Anti-Abuse Tax," or BEAT.[23] The BEAT is essentially a 10 percent minimum tax (5 percent in 2018) that is meant to prevent foreign and domestic corporations operating in the United States from avoiding domestic tax liability by shifting profits out of the United States. The scope of the BEAT is limited to large multinational corporations with gross receipts of $500 million or more. The BEAT also does not apply unless "base erosion" payments, payments that corporations based in the U.S. make to related foreign corporations, exceed 3 percent (2 percent for certain financial firms) of total deductions taken by a corporation.

The BEAT works much like a minimum tax. Corporations pay BEAT to the extent it exceeds its ordinary corporate income tax liability. As such, BEAT is equal to 10 percent (5 percent in 2018) of "modified taxable income" minus regular corporate income tax liability (not to go below zero). Modified taxable income is calculated by taking ordinary taxable income and adding back "base erosion" payments made to related foreign corporations (in effect, disallowing the deduction for these costs). These payments added back to taxable income to construct modified taxable income include payments for services, interest, rents, and royalties, and deductions for depreciation and amortization. However, payments for costs of goods sold, the deductions for GILTI and FDII, and the dividends-received deduction (the participation exemption) are not added back.

Suppose a corporation in the United States has gross receipts of $500 million, expenses of $480 million, and taxable income of $20 million. Under the ordinary corporate income tax this corporation's tax liability would be $4.2 million (21 percent of $20 million). This corporation's payments to a CFC based in a foreign country totaled $50 million, so it well exceeded the 3 percent of total deductions' threshold. The company's modified taxable income with respect to BEAT is $70 million, which is equal to its taxable income ($20 million) plus the payments it made to a foreign CFC ($50 million). As such, its total tax liability is $7 billion ($4.2 million in ordinary corporate tax plus $2.8 million, the excess of BEAT over ordinary corporate liability).

21 Given some of the interactions between GILTI and FDII and the limitation on foreign tax credit, it may be the case still that intellectual property may face different rates depending on its location.

22 Pomerleau and Jahnsen, "Designing a Territorial Tax System: A Review of OECD Systems."

23 26 U.S. Code § 59A - Tax on base erosion payments of taxpayers with substantial gross receipts.

TABLE 4.

Example BEAT Calculation (millions of dollars)

Total U.S. Gross Receipts	$500
Total U.S. Expenses	$480
Taxable Income	$20
Corporate Income Tax Liability @21%	$4.2
BEAT Liability	
Taxable Income	$20
Plus	
Base Erosion Payments	$50
Equals	
Modified Taxable Income	$70
BEAT Liability @10%	$7

Scheduled Changes to the New International Provisions

The TCJA includes scheduled changes over the next decade that will impact the GILTI, FDII, and BEAT. All three scheduled changes are set to raise the tax burden on U.S. multinational corporations.

GILTI: In 2026, the deduction for GILTI is scheduled to decrease from 50 percent to 37.5 percent. As a result, the overall effective tax rate on GILTI will rise from 13.125 percent to 16.406 percent, including the effect of the 80 percent foreign tax credit.[24]

FDII: In 2026, the deduction for FDII is scheduled to decrease from 37.5 percent to 21.875 percent. As a result, the effective tax rate on FDII will rise to 16.406 percent.[25]

BEAT: In 2026, the BEAT rate will increase from 10 percent to 12.5 percent.[26]

24 26 U.S. Code § 250 - Foreign-derived intangible income and global intangible low-taxed income.

25 Ibid.

26 26 U.S. Code § 59A - Tax on base erosion payments of taxpayers with substantial gross receipts.

The U.S. Tax System is Not a Pure "Territorial" Tax System

The current U.S. tax system is often described as a territorial tax system. However, it is not a pure territorial or source-based corporate income tax. The new system can more accurately be described as a hybrid system that borrows pieces from different principles of international taxation.

There are three distinct principles of international taxation: source-based (territorial), residence-based (worldwide), and destination-based. Each principle attempts to define when and how corporate profits are taxable within a country.

- **Source-based ("territorial")**

  Under a source-based or "territorial" corporate tax system, corporate profits are taxed based on where goods and services are produced. As such, taxation does not depend on where a company is headquartered; it only matters where goods are produced. Under this system, only profits earned in the United States would be taxed while foreign profits would be completely exempt.

- **Residence-based ("worldwide")**

  Under a residence-based corporate tax system, corporate profits are taxed based on the residence of a corporation, or the location of its headquarters. Under this system, which the U.S. employed more fully until the passage of the TCJA, a corporation headquartered in the United States would be subject to the U.S. corporate tax on its worldwide profits. However, to prevent double-taxation under a residence-based system, the U.S. would provide a foreign tax credit for any foreign taxes already paid on that income (up to the U.S. tax rate).

- **Destination-based**

  Under a destination-based tax system, corporate profits are taxed based on where goods and services are sold. Under this system, it doesn't matter where a company is headquartered, nor does it matter where goods are produced. Companies are instead taxed based on the location of their customer.

The TCJA's reforms to the international tax system borrowed aspects from all three principles of taxation.

The participation exemption, that is, the 100 percent deduction for foreign profits paid back to U.S. parent companies, is the key component of a territorial, or source-based tax system that eliminates domestic tax on foreign profits.

GILTI conforms more to the residence principle. As such, taxation under GILTI depends on where a company is headquartered. Multinational corporations headquartered in the United States are subject to taxation on their GILTI earned abroad, whereas companies that are headquartered

elsewhere are not. However, it is worth noting that GILTI is much narrower in scope than a pure worldwide, or residence-based system. A full worldwide system would include all profits earned by a corporation each year in which they were earned. GILTI, instead, limits the taxation to "supernormal" returns, or returns in excess of 10 percent of qualified investments. This aspect of GILTI more closely resembles how a destination-based tax impacts foreign investment.[27]

FDII and BEAT somewhat resemble a destination-based tax system. A key component of a destination-based corporate tax is a border adjustment. A border adjustment taxes imports and provides an exemption for exports. The BEAT, which disallows certain deductions for payments to foreign-affiliated corporations, effectively adds certain imports into the tax base the same way a destination-based tax would. The FDII, which provides a reduced tax rate for export-related income, is in the spirit of the full exemption for export sales that a border adjustment provides.

The U.S. System is Similar to Those Employed by Other Nations in Some Ways and Different in Others

While the new U.S. system for taxing foreign profits is more of a hybrid system than a pure territorial tax system, it is not unique in that regard among other industrialized nations. Most countries in the OECD employ hybrid systems that eliminate the domestic tax on foreign earnings through a participation exemption, but also protect the domestic tax base through rules that are based on corporate residence.

With the introduction of the participation exemption, the United Stated moved more in line with the majority of OECD nations. In 2017, 29 of 35 OECD nations exempted foreign earnings from domestic taxation.[28] However, the U.S. participation exemption is more similar to the Canadian or Japanese exemption systems, which also do not exempt capital gains, whereas most European nations exempt both dividends and capital gains.

The United States is also not alone in enacting anti-base erosion provisions alongside its participation exemption. Most OECD nations with participation exemptions (20 of the 29 countries with exemptions) also employ what are called CFC rules.[29] Much like GILTI, CFC rules are residence-based, meaning that they only apply to domestically headquartered multinational corporations, and are aimed at preventing companies from avoiding domestic tax liability through certain business arrangements.

CFC rules are complex, but they attempt to accomplish a similar goal as GILTI: taxing what is considered easily shifted income, while exempting income attributable to real investments. However, there are important differences to note. First, GILTI uses a much more formulaic approach (10 percent of qualifying investments) to determine what income is exempt than do traditional CFC rules, which use something like a facts and circumstances approach. Second, when GILTI applies, it taxes the income at a reduced rate, whereas CFC rules usually apply the full domestic rate.

27 William B. Barker, "A Common Sense Corporate Tax: The Case for a Destination-Based, Cash Flow Tax on Corporations," *Catholic University Law Review* 61:4 (2012). https://scholarship.law.edu/cgi/viewcontent.cgi?article=1033&context=lawreview

28 Pomerleau and Jahnsen, "Designing a Territorial Tax System: A Review of OECD Systems."

29 Ibid.

The taxation of FDII is very similar to a policy employed by many nations: a patent box. A patent box is a tax regime that provides a special, reduced tax rate to income attributable to intellectual property. Over the last decade, patent boxes have grown in popularity, and as of last year, 11 OECD nations had patent boxes.[30] The major difference, however, between FDII and a traditional patent box is that FDII only applies to export-related income whereas patent boxes apply to all income attributable to intellectual property.

Conclusion

Before the passage of the Tax Cuts and Jobs Act, the U.S. was one of the few countries in the OECD with a worldwide corporate tax system. This system was flawed. The new U.S. international tax regime is better. It is not perfect. Designing any territorial tax system requires making a number of important trade-offs, and by no means is the new system a pure "territorial" tax system. Nonetheless, by moving towards a territorial tax system, lawmakers made important improvements to the way the United States taxes U.S. multinationals.

30 Kyle Pomerleau, Scott Hodge, and Jared Walczak, *2017 International Tax Competitiveness Index*, Tax Foundation, October 2017. https://files.taxfoundation.org/20171030112339/TaxFoundation-ITCI-2017.pdf