Department of Law
Spring Term 2018

Master Programme in International Tax Law and EU Tax Law
Master’s Thesis 30 ECTS

Tangible Intangibles in the United States’ Tax Cuts and Jobs Act
How Mixed Definitions of “Intangible” Lead to Mixed Results in the United States’ Efforts to Close Tax Loopholes, Move to a Territorial Tax System, and Reduce Base Erosion and Profit Shifting Abuses

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Abstract

The United States’ Tax Cuts and Jobs Act of 2017 (TCJA) changed a 30-year-old definition of the term “intangible property” and added assessment requirements for two different types of “intangible income”, both of which deviate from the newly changed general definition of “intangible” and most common understandings of the meaning of the word. While it may appear unlikely that a change in meaning of a single word in a large tax code could have a drastic effect on international taxation, the differing definitions of “intangible” create far-reaching tangible consequences.

The TCJA affects the international taxation of US-based corporations for cross-border transactions, among many ways, by employing different definitions of the word “intangible” in three different provisions. First, it modifies the general statutory definition of “intangible” to specifically include goodwill, workforce in place, and going-concern value will be examined. Second, it uses an unusually broad definition of “intangible” in the new tax category of global intangible low-taxed income (GILTI); and third, the meaning of “intangible” as used in assessing so-called foreign-derived intangible income (FDII) essentially creates a broad export subsidy. Each use of the term will also be assessed on how it ties into the TCJA’s intended purpose for the provision in which it appears. Additionally, they will be assessed on how they compare with established international tax standards
provided by the Organization for Economic Co-operation and Development (OECD) and its Base Erosion and Profit Shifting (BEPS) Plan.

By explicitly changing the definition of “intangible property”, it becomes apparent that the TCJA has increased the scope of potential tax liability for US corporations and has brought the US in line with the OECD’s use of the phrase as used in its model convention.

In examining how the GILTI tax is calculated, it will become evident that the tax can be applied to income that is not connected to intangibles despite the seemingly limited scope implied by its name. Furthermore, a limitation on foreign tax credit means that GILTI might allow at least some continuation of the old worldwide tax system. While potentially overly-burdensome, GILTI seems to be broadly in line with the BEPS goal towards reducing profit shifting.

As a result of how “intangible” is defined for purposes of determining FDII, two effects become apparent. First, for tax categorization, it encompasses income from both tangible and intangible assets. Second, it permits deductions that can be construed as an export incentive.
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<td>Agreement on Subsidies and Countervailing Measures</td>
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1. Introduction

1.1 Problem Description

A natural starting-point for determining the meaning of tax-related statutes in the United States’ tax code, indeed any statute, is analyzing the commonly understood meaning of the words comprising the provisions. However, the legislature often incorporates unique definitions for words to be used when parsing the statutory text and such definitions are not always closely related to commonly understood meanings or even alternative meanings provided for in dictionaries. Furthermore, in a dispute, the judiciary may read the statute with other meanings in order to avoid absurd or contradictory results.

These non-standard statutorily-provided definitions can have unintended effects on the scope of the statute; rendering it less effective than one might assume or extending it beyond reasonable expectations. In an international tax context, undesirable effects stemming from unusual definitions can lead to retaliatory measures from organization members.

The United States’ Tax Cuts and Jobs Act of 2017 (TCJA) changed a 30-year-old definition of the term “intangible property” and added assessment requirements for two different types of “intangible income”, both of which deviate from the newly changed general definition of “intangible” and most
common understandings of the meaning of the word. While it may appear unlikely that a change in meaning of a single word in a large tax code could have a drastic effect on international taxation, the differing definitions of “intangible” create far-reaching tangible consequences.

1.2 Objective

The purpose of this thesis is to assess how different meanings of the word “intangible”, brought about by the TCJA, affects the international taxation of US-based corporations for cross-border transactions. Specifically, this thesis will focus on three different uses of “intangible”: First, the modified general statutory definition of “intangible” to specifically include goodwill, workforce in place, and going-concern value will be examined; second, “intangible” as used in the new tax category of global intangible low-taxed income (GILTI); and third, the meaning of “intangible” as used in assessing the new deduction allowable for foreign-derived intangible income (FDII). Each use will be assessed on how it ties into the TCJA’s intended purpose for the provision in which it appears. Additionally, they will be assessed on how they compare with established international tax standards provided by the Organization for Economic Co-operation and Development (OECD) and its Base Erosion and Profit Shifting (BEPS) Plan.
1.3 Delimitations

This thesis will analyze how three of the TCJA’s differing definitions for the word “intangible” lead to changes in the historic scope of international income tax treatment for US multinational corporations (MNCs) and how they compare with the goals of the OECD’s BEPS Project and Transfer Pricing Guidelines in complying with international tax norms. In doing so, this thesis will analyze the TCJA, the United States’ tax code, and US domestic law. It will also focus on OECD materials such as the BEPS Action Plans and Transfer Pricing Guidelines, as well as the World Trade Organization’s (WTO) Agreement on Subsidies and Countervailing Measures (ASCM).

This thesis will not address historical US tax policies or provide an in-depth analysis of the circumstances that led to the TCJA’s enactment. A high-level background will be provided at the beginning of each chapter to allow for some context in viewing the new TCJA provisions within the US Internal Revenue Code (IRC), but it will not serve as a critique of either the old or new tax plan at large. The reader need not be an expert on the United States’ legal system, however, it is assumed that the reader understands that the US legal system is rooted in federalist principles and a common law tradition.

The historic backgrounds of international organizations such as the OECD and WTO are not discussed. The legal validity of their guidelines,
recommendations, and actions are also not addressed. The reader is expected to be generally familiar with the functions and purposes of these international organizations. Additionally, the reader should assume that the goals and standards provided by these organization constitute international norms. While other organizations may share or dispute these standards, they will not be addressed in this thesis.

Throughout the thesis, the effects of the pertinent TCJA provisions will be compared against the OECD regarding select defined terms and the broad goals of the BEPS Project. Both the OECD and BEPS cover a wide breadth of issues this thesis does not claim to address. This thesis will only look at a few instances of how certain items are treated as intangibles and will only touch upon the general aims of BEPS. This thesis is not intended to provide an in-depth analysis of the policy goals of the OECD/BEPS, nor is it intended to serve as a critique of their methodology. In chapter four, the assessment of a prohibited subsidy will be analyzed under the WTO’s ASCM. The other articles of the ASCM that do not address prohibited subsidies are beyond the scope of this thesis and will not be discussed. Similarly, this thesis is not intended to serve as an analysis or critique of the WTO’s workings.

The thesis will focus only on the TCJA’s effect on standard corporate business entities. While the TCJA applies to all persons liable to US tax, natural
individuals and pass-through tax entities are largely treated differently from corporations under the TCJA and are also treated differently between themselves depending on their type (e.g. partnerships, limited partnerships, limited liability companies, etc.). Furthermore, the FDII deduction discussed in chapter 4 as well as certain provisions related to GILTI are only applicable to non-pass-through corporate tax-entities. While the different definitions of “intangible” undoubtedly has similar consequences to non-corporate taxpayers as it does for corporations, such consequences will not be addressed.

1.4 Methods and Materials

For assessments of United States tax law, the doctrinal legal methodology is appropriate. Such a method requires consideration of both the statutory language of the relevant legislation as well as the applicable case law influencing how such language should be interpreted. Therefore, the TCJA, the IRC, and US case law will be the primary sources used in this area of research. In analyzing the perceived meaning of “intangible” within the three provisions and the probable scope of those provisions’ I will use the doctrinal method by first focusing on the meaning of the words based on their statutorily prescribed

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1 The doctrinal method is analogous to the legal-dogmatic method and functionally identical. The difference between the two is largely one of regional naming-convention. In civil law countries, some variation of “legal-dogmatic” is the preferred name, while common law countries often refer to the “doctrinal legal” analysis. As the US is a common law country, I have elected for the “doctrinal legal methodology”.
definitions and then harmonizing that definition with guiding case law on statutory interpretation. Because the TCJA was passed less than six months before this thesis was written, there is no case law on the subject and very little official guidance about how its provisions should be interpreted. As such, I will focus on analyzing the language of the statute using the prescribed method of interpretation traditionally used by US courts.

When the TCJA was enacted, it was incorporated into the IRC by modifying existing provisions and by adding entirely new provisions. Because this thesis focuses on the specific language of the TCJA and its effect on the obligations of corporate taxpayers as prescribed by the IRC, the TCJA and the IRC will be the primary sources regarding the statutory component of US domestic law. For judicial interpretation of the pre-TCJA tax code, the US Tax Court cases *Veritas Software Corp. v. Commissioner of Internal Revenue* and *Amazon.Com, Inc. v. Commissioner of Internal Revenue* illustrate how courts viewed the language of the statute as permitting the exclusion of certain soft intangible sources of income. The US Tax Court’s decisions provide informative guidance for addressing tax controversies. While this court’s decisions are subject to review by the US Courts of Appeals, its decisions stand in the jurisdiction of the controversy unless overturned on appeal. Because the controversies regarding the exclusion of soft intangible assets were never addressed on appeal and never went before the Supreme Court, it cannot be definitively stated that this loophole
unquestionably existed throughout the entire US. However, considering the thirty-year period in which the previous tax code existed, the fact that the controversy was not addressed on appeal and was never selected for review by the Supreme Court suggests that the Tax Court’s decisions were soundly reasoned.

Similarly, the US Supreme Court Case *Cook v. Tait* illustrates the judicial branch’s interpretation of the IRC as permitting taxation on a US citizen’s worldwide income. Because this case went before the Supreme Court, the decision interpreting the authority of the government to tax its citizens on their worldwide income was binding in all US jurisdictions. Therefore, the old US tax system can be stated with certainty as being a worldwide tax system.

For information on how the judiciary interprets statutes, the US Supreme Court cases *Stenberg v. Carhart*, *Lamie v. U.S. Treasury* (which quotes *Caminetti v. United States*), and *Murray v. The Schooner Charming Betsy*, are illustrative. The holdings and procedure for analyzing statutes have become touchstones within the US legal tradition. As such, the cases selected for this thesis are just a small sampling of the cases that outline these procedures. Because these procedural elements originate within the US Supreme Court, have been used for nearly a century, and are cited in many other Supreme Court cases and lower
court cases, they provide a good indication of how a hypothetical controversy would likely be analyzed by a US court.

In the realm of international tax law and standards, traditional dogmatic or doctrinal methodology is inapplicable because there is no over-arching authority or statutory system. As such, the guidance, recommendations, and treaties provided by the OECD and WTO, prominent international organizations will serve as the primary sources for international law area of research. In particular, the OECD’s BEPS Actions 8–10 Final Reports, Glossary of Tax Terms, Transfer Pricing Guidelines, and the WTO’s ASCM provide relevant insight and points of comparison to this thesis’s area of focus. These instruments, references, and agreements cover areas beyond the scope of this thesis which have thus not been thoroughly researched for its purpose.

1.5 Outline

Because this thesis aims to assess the effects of the TCJA’s changes to the meaning of “intangible,” I thought it prudent to begin the second chapter by discussing how “intangible” was previously defined in the statute and how courts interpreted the language. This chapter will examine how the phrase “intangible property” has historically been defined in a way that limits the tax consequences to US corporations. Following this brief historic background, there will be an overview of how the new definition under the TCJA will
discourage US corporations from using overseas tax shelters. The chapter will then consider the consequences of the new definition attached to the phrase, such as how it will discourage US corporations from using overseas tax shelters. By explicitly changing the definition of “intangible property”, it becomes apparent that the TCJA has increased the scope of potential tax liability for US corporations and has brought the US in line with the OECD’s use of the phrase as used in its model convention.

The third chapter will address the new income category of GILTI and its corresponding tax. This overview will provide an explanation as to why the GILTI tax was created and how it is calculated for the taxpayer. In examining how the GILTI tax is calculated, it will become apparent that the tax can be applied to income that is not connected to intangibles despite the seemingly limited scope implied by its name. The wording of the calculation method for GILTI suggests that the TCJA might be a less radical move towards a territorial tax system than it was initially portrayed. Finally, there will be an examination of how the GILTI provision is perceived in the European Union (EU) and how it compares with the policy goals of the OECD and the BEPS project.

The fourth chapter will focus on FDII and will begin with an overview of this newly created income category. This overview will provide some background on the FDII and why it was added into the IRC. Next, a guide for calculating
the FDII and its deduction will be provided. This guide will illustrate how the prescribed calculation method expands its scope beyond intangible income. Finally, there will be an examination of how the FDII provision is perceived in the EU and how it compares with the policy goals of the OECD and the BEPS project.
2. The Definition of “Intangible Property”

2.1 Introduction

In this chapter, there will be an overview of how changing the definition of intangible property will discourage US corporations from using overseas tax shelters. The scope and effect that a law has in the United States is largely dependent on how the words used in a code or treaty are defined. This chapter will begin by examining how the phrase “intangible property” has historically been defined in a way that limits the tax consequences to US corporations. The chapter will then consider the consequences of the new definition attached to the phrase. The change in definition for “intangible property” accomplishes two things. First, it brings the US in alignment with the OECD’s understanding of the term. Second, it closes a valuation loophole that when coupled with the lowered US corporate tax rate might have been exploited for tax purposes. By explicitly changing the definition of “intangible property”, the TCJA has increased the scope of potential tax liability for US corporations and has brought the US in line with the OECD’s use of the phrase as used in its model convention.
2.2 Historic Connection in the United States Between Income Tax and Intangible Property

In the United States, all taxpayers—including corporate taxpayers—income, from whatever source, is subject to tax.\(^2\) For multinational corporations (MNCs), this income includes profits from consumer sales, dividend payments from investment instruments, and proceeds from the distribution of assets.\(^3\) For tax purposes, these assets can be divided into two broad groups, tangible assets and intangible assets. Tangible assets are, as the name suggests, physical property that can be touched: Factory equipment, shipping vehicles, and manufacturing tools are all types of tangible assets. Intangible assets, however, are less easily discerned.

Broadly, intangible assets are those assets that lack a physical form but provide some benefit to their owner. Copyrights, patents, and trademarks are classic examples of assets that have no innate physical properties—though they can be expressed in a physical format such as a blueprint, book, or drawing—but provide potentially valuable rights and ideas that can be transferred to others in a


\(^3\) See 26 U.S.C. § 61(a). ‘[G]ross income means all income from whatever source derived including (but not limited to) the following ... (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends[.]’
business transaction. While these examples are generally recognized by most nations, they are by no means exhaustive of the category of intangibles.

For all US based taxpayers, including MNCs, defined terms for tax purposes have been found in the US Internal Revenue Code (IRC). Unless a treaty to which the US is a party provides alternative definitions and controls in a particular transaction, then any term defined in the IRC carries its provided meaning in any transaction involving the US taxpayer. In the previous IRC, which was effective between October 22, 1986 and December 21, 2017, intangible property was defined in the US as:

(B) Intangible property.--The term “intangible property” means any--

(i) patent, invention, formula, process, design, pattern, or know-how;

(ii) copyright, literary, musical, or artistic composition;

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4 For example, see 26 U.S.C. § 854(b)(1)(B)(ii). For purposes of determining maximum tax rates on dividends in certain circumstances, gross income is defined as the excess of the net short-term capital gain over the net long-term capital loss.

5 Stenberg v. Carhart, 530 U.S. 914, 942 (2000) (US Supreme Court) ‘When a statute includes an explicit definition, we must follow that definition ....’; Murray v. Schooner Charming Betsy, The, 6 U.S. 64 (1804) (US Supreme Court) ‘It has also been observed that an act of Congress ought never to be construed to violate the law of nations if any other possible construction remains, and consequently can never be construed to violate neutral rights, or to affect neutral commerce, further than is warranted by the law of nations as understood in this country. These principles are believed to be correct, and they ought to be kept in view in construing the act now under consideration.’
(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; or

(vi) any similar item

which has substantial value independent of the services of any individual.\(^6\)

This definition allows a distinction to be made between different types of intangible assets. For example, a copyright, patent, or the other items listed in (B)(i)–(v) would not be excludable from intangible assets because mere ownership of these items confers either specific rights or quantifiable abilities to the owner. In contrast, goodwill, going concern value, and workforce in place derive their values based on a person or company’s previous actions and performances. The distinction between types of intangible property was critical from a tax perspective. While, intangible property is not in itself taxed in in the United States, income connected to the intangible property was taxed only if the property in question could be categorized in 26 U.S.C. § 936.\(^7\)

\(^6\) See 26 U.S.C. § 936 as was valid from 1986 through 31 December 2017.
\(^7\) See 26 U.S.C. § 61(a). Gross income means ‘all income from whatever sourced derived[,]’
The two types of broad intangible property classes are recognized in many countries. The OECD recognizes this division as being between “hard” intangibles (patents, copyrights, trademarks, etc.) and “soft intangibles” (goodwill, workforce in place, ongoing concern value). While the OECD and US revenue code essentially agree on what constitutes “hard” intangibles and how they should be treated for tax purposes, they have traditionally disagreed as to how certain “soft” intangibles should be treated.

2.3 Historical Divergence in the Definition of Intangible Property

The OECD has already accepted assembled workforce, goodwill, and ongoing concern value as intangible assets. These assets fall into the “soft” intangible category. Like other intangible assets, BEPS Actions 8–10 Final Report advises that assembled workforce, goodwill, and ongoing concern value should be factored into a transfer pricing comparability analysis. The Action Plans note that goodwill and ongoing concern lack a single definition that can be applied in

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8 OECD (2015), Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Actions 8–10 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, paragraph 6.15. ‘Distinctions are sometimes made between trade intangibles and marketing intangibles, between “soft” intangibles and “hard” intangibles, between routine and non-routine intangibles, and between other classes and categories of intangibles.’

9 See ibid, paragraph 6.27.

10 Ibid, paragraphs 1.152, 6.29
all circumstances.\textsuperscript{11} However, any hindrance caused by lacking a precise
definition of what constitutes goodwill or ongoing concern is mitigated by
focusing on the result goodwill or ongoing concern has on a transaction. These
intangibles can be determined to exist whenever an asset’s value reflects a
reputation-based element derived by the disposing party’s conduct and that such
a component should be taken into consideration when establishing an arm’s
length price.\textsuperscript{12}

In the United States, the status of such “soft” intangibles were less certain.
Beginning with the language of the statute, the wording of 26 U.S.C. §
936(h)(3)(B)(vi) allowed taxpayers to make the argument that any income
connected to “soft” intangible assets that depended on personal involvement to
achieve its value could be excluded from taxable intangible property income.
Goodwill and going concern value are essentially the reputation that a company
has obtained as a result of its services. While a good reputation with the public
and prospective customer base is certainly an asset to any company, its value is
not born out of any rights or knowledge automatically bestowed upon
possession. Without the company’s services, the positive reputation embodied

\textsuperscript{11} \textit{Ibid}, paragraph 6.27.
\textsuperscript{12} \textit{See ibid}, paragraph 6.28. ‘It is important to recognise, however, that an important
and monetarily significant part of the compensation paid between independent
enterprises when some or all of the assets of an operating business are transferred
may represent compensation for something referred to in one or another of the
alternative descriptions of goodwill or ongoing concern value.’
in the goodwill or going concern would not exist. As a result, goodwill and going concern value would not be covered as intangibles for tax purposes under § 936(h)(3)(B)(vi). This interpretation of § 936(h)(3)(B)(vi) allowed US MNCs, such as Veritas Software Corp. and Amazon.Com, Inc. to exclude from their taxes transfers involving goodwill, going concern value, workforce in place, or any other item that lacked value without a direct connection to tangible property or an individual’s service.¹³

2.4 The New Definition of Intangible Property in the United States

The TCJA amends the IRC’s definition of intangible property by explicitly including workforce in place, going-concern value, and goodwill in its list of specifically covered property types. By including these assets directly within statute, their inclusion in an IRS assessment is unlikely to be dismissed by a

¹³ Veritas Software Corp. v. Comm'r of Internal Revenue, 133 T.C. 297, 316 (2009) (US Tax Court). The US Tax Court held that the IRS improperly determined that the parent company, Veritas US, did not receive arm’s-length consideration from its subsidiary, Veritas Ireland, in a transfer of intangible property. The Tax Court noted that the IRS was not authorized to include workforce in place, goodwill, or going concern value in assessing the arm’s-length value.; Amazon.Com, Inc. v. Comm'r of Internal Revenue, 148 T.C. 8, 29 (2017) (US Tax Court). The US Tax Court found the IRS again improperly considered the appropriate intangibles, stating ‘as we concluded in Veritas, there was for the tax years at issue “no explicit authorization” in the cost sharing regulations for “respondent's ‘akin’ to a sale theory or [his] inclusion of workforce in place, goodwill, or going-concern value” in determining the buy-in payment for pre-existing intangibles.’
reviewing court as an overstepping of authority by the IRS.\textsuperscript{14} The judiciary’s principles of interpretation will almost certainly preclude any taxpayer arguments that goodwill, workforce in place, and going-concern value can be ignored when performing an arm’s-length valuation.\textsuperscript{15} The implicit exclusion of any asset that required an individual’s service in order to have value from intangible property is retained, however, and to that extent may still see US MNCs exclude income from assets that would be covered under the OECD’s broader interpretation.\textsuperscript{16}

While settled tax disputes for tax years ending before 1 January 2018 will not be overturned for retroactive application of the new definition, for all future tax assessments, and possibly some current disputes in certain jurisdictions, the new definition will prevail. For Veritas Software Corp. and Amazon.Com, Inc., the prior rulings permitting them to exclude workforce in place, goodwill, and going concern value from their intellectual property valuations will carry little weight in any argument that they should be allowed to continue such exclusions. The

\begin{itemize}
  \item \textsuperscript{14} For example, see Veritas Software Corp. v. Comm'r of Internal Revenue and Amazon.Com, Inc. v. Comm'r of Internal Revenue.
  \item \textsuperscript{15} Lamie v. U.S. Tr., 540 U.S. 526, 534 (2004) (US Supreme Court). ‘It is well established that “when the statute's language is plain, the sole function of the courts—at least where the disposition required by the text is not absurd—is to enforce it according to its terms.”’ quoting Caminetti v. United States, 242 U.S. 470, 485, (1917) (US Supreme Court).
  \item \textsuperscript{16} See 26 U.S.C. § 936(h)(3)(B)(vii). Intangible property is defined as ‘any other item the value or potential value of which is not attributable to tangible property or the services of any individual.’
\end{itemize}
change in the definition of intangible property has likely closed the intangible property valuation loophole.

2.5 How the United States’ New Definition for Intangible Property aligns with the OECD

The TCJA brings the United States closer to alignment with the OECD in the treatment of intangibles by explicitly defining intangible property to include goodwill, workforce in place, and going-concern value and closing an intangible property valuation loophole. The OECD had previously established a definition of “intangible property” that specifically encompassed goodwill. While ongoing concern (the synonymous OECD term for going-concern value) and workforce in place were not explicitly provided for in the OECD Glossary of Tax Terms, they were recognized, in addition to goodwill, in the Transfer Pricing Guidelines.

The exclusion from intangible property valuation of three potentially vast sources of an asset’s value carried a high risk of being used in tax-avoidance schemes. The US was likely unable to keep or attract intellectual property from

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MNCs on the basis of its generally high tax rate. With the new lower tax rate provided by the TCJA, the old definition of intangible property might have led some MNCs to consider the US when locating their intellectual property. Closing the valuation loophole by changing the definition allows the US to comply with international norms as it reduces its overall corporate tax rate by not providing unfair tax incentives to attract business.

3.1 Introduction

In this chapter, the new GILTI tax will be analyzed. First, an overview will provide an explanation as to why the GILTI tax was created. Next, a walkthrough of how GILTI is calculated for the taxpayer will be provided. In examining how the GILTI tax is calculated, it will become apparent that the tax can be applied to income that is not connected to intangibles despite the seemingly limited scope implied by its name. The complex definition of GILTI, which consists of a complex series of calculations and is comprised at least partially of income from tangible property, suggests that the TCJA might be a less radical move towards a territorial tax system than it was initially portrayed. Finally, there will be an examination of how the GILTI provision is perceived in the EU and how it compares with the policy goals of the OECD and the BEPS project.
3.2 Creation of the Global Intangible Low-Taxed Income

One of the primary functions of the TCJA was to shift the US international tax regime from a worldwide system to a territorial system. Under its worldwide system of international tax, US taxpayers were taxed at their US tax rates on any income they received whether the income originated within the United States or any other country. While theoretically onerous, in reality, the US system allowed individual taxpayers to seek relief through a variety of means. For example, double taxation was avoided or mitigated through tax treaties and foreign tax credits and taxpayers could routinely take advantage of deductions that reduced their effective tax burden to rates far below the rates prescribed for their income brackets depending on their specific circumstances. Generally, however, under a worldwide tax system, a US resident taxpayer is incapable of taking advantage of lower-tax jurisdictions because any profits shifted abroad will still be taxed in the US at the higher US tax rates.

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19 See 26 U.S.C. § 965. US Shareholders are now more broadly permitted to deduct from their gross income certain amounts of foreign income.
20 See 26 U.S.C. § 61(a) ‘[G]ross income means all income from whatever source derived[,]’; See also Cook v. Tait, 265 U.S. 47, 56 (1924) (US Supreme Court). ‘[T]he basis of the power to tax was not and cannot be made dependent upon the situs of the property … nor was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen.’
Despite the various avenues of relief available to taxpayers, the combination of the high US corporate tax rate and the broad rule that all income is taxable barring the taxpayer’s qualification for exemption dependent on the specific circumstances of the taxpayer meant that from a corporate tax planning perspective, the worldwide system created a significant risk of a heavy tax burden. As a result, many corporations—particularly those whose non-US-based activities comprised a large portion of their operations—took advantage of the limited general applicability of the IRC to US residents by conducting corporate inversions in order to establish themselves as resident taxpayers of other countries and take advantage of their territorial tax systems.21 While these corporations were still subject to US tax law on their US-based operations, the territorial tax systems and lower corporate tax rates of their adopted home-countries allowed them to achieve more favorable tax results and to do so with greater certainty than if they were to attempt to use the deductions and exemptions of the IRC to reduce their effective tax rate.

The trend of US corporations inverting themselves as foreign corporations to escape the high tax rates and worldwide international tax system inspired the US

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legislature to reform its tax laws and move to a territorial tax system. This shift necessitated new laws to curb the threat of abuse inherent in a territorial system. One of the perils of a territorial tax system is the incentive for corporations to characterize their income as originating in lower-tax jurisdictions and the difficulty tax revenue collectors face in determining the accuracy of a corporation’s characterization of its income. To discourage corporations from shifting their income to lower-tax countries, the TCJA introduced a provision into the IRC which requires US shareholders of any controlled foreign corporation (CFC) to include in their gross income any of their GILTI and pay tax on any such amount. In other words, despite the shift to a territorial tax system, corporate shareholders will still be taxed on their extraterritorial income if the source country does not tax their corporate income at a sufficient rate.

3.3 Determining Who Is Subject to the Global Intangible Low-Taxed Income Tax

The GILTI tax is applicable to US shareholders’ income derived from foreign corporations if certain criteria are met. Generally, each person who is a US

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23 26 U.S.C. § 951A.
shareholder of any CFC shall include in gross income the shareholder’s GILTI.\textsuperscript{24} As used in this provision, a US shareholder is defined as a person, including natural persons and corporations, that owns stock, either directly or indirectly, in a foreign corporation.\textsuperscript{25} 

A CFC, as used in this provision, is one in which a shareholder owns stock in an amount of 25 percent or more of the total combined voting power of all shares entitled to vote or the total value of the stock in a foreign corporation.\textsuperscript{26} If a person fits the definition of a US Shareholder of a CFC, then for any taxable year in which they fit that definition, that person shall include in their gross income any income derived from the CFC during that taxable year.\textsuperscript{27}

### 3.3.1 Determining a Taxpayer’s Global Intangible Low-Taxed Income

GILTI is defined as the excess of the US shareholder’s net CFC tested income for the taxable year, over the US Shareholder’s net deemed tangible income.

\begin{itemize}
\item \textsuperscript{24} 26 U.S.C. § 951A(a).
\item \textsuperscript{25} See 26 U.S.C. § 6652(c)(6)(C). A person is defined as an ‘officer, director, trustee, employee, or other individual[.]’; 26 U.S.C. § 958(a) Stock ownership is defined as either being through direct ownership by the person or directly or indirectly through a foreign entity by the shareholder’s ownership of the foreign entity’s stock.
\item \textsuperscript{26} 26 U.S.C. § 904(d)(5)(A). A controlled foreign corporation is defined as being a foreign corporation with more than either 50 percent of the combined voting power of all classes of stock or the total value of the corporation’s stock is held by US shareholders on any day during the corporation’s taxable year.
\item \textsuperscript{27} 26 U.S.C. § 951A(a).
\end{itemize}
return for the taxable year. In formulaic notation, GILTI = net CFC income - 
[(10 percent x qualified business asset interest) - interest expense].

A shareholder’s net CFC tested income is the shareholder’s pro rata share of the 
excess of the CFC’s tested income over the CFC’s tested losses. A CFC’s tested income is the excess of the corporation’s gross income (excluding 
subchapter F income, US-sourced income, dividends received from related 
persons, income excluded from the foreign base company income, payments 
from an insurance or annuity contract, and income from foreign oil and gas 
extraction) over the deductions (including taxes) properly allocable to this gross 
income amount. A CFC’s tested loss is the excess of the deductions (including 
taxes) properly allocable to the gross income over the gross income.

The net deemed tangible income return is the excess of 10 percent of the 
shareholder’s aggregate qualified business asset investment over the amount of 
interest expense considered in determining the deductions properly allocable to 
gross income when determining the CFC’s tested income to the extent that the 
interest attributable to the expense is not considered in determining the

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shareholder’s net CFC tested income. As this income is included in the taxpayer’s gross income, it becomes liable to tax.

3.3.2 Calculating the Global Intangible Low-Taxed Income Tax

For corporate tax payers, the new tax rate under the TCJA is 21 percent. Because GILTI is included in the corporate taxpayer’s gross income it is nominally taxed at the standard 21 percent rate. However, the TCJA allows corporate taxpayers to deduct 50 percent of their GILTI amount whether included in gross income or treated as a dividend. This deduction is limited only when the deductions exceed domestic income. For corporations, the GILTI tax is essentially a tax on certain worldwide income at a rate of 10.5 percent. However, this effective GILTI tax rate lasts only through 31

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33 26 U.S.C. § 951A(b)(2). See 26 U.S.C. § 951A(d)(1) ‘In general: The term “qualified business asset investment” means, with respect to any controlled foreign corporation for any taxable year, the average of such corporation’s aggregate adjusted bases as of the close of each quarter of such taxable year in specified tangible property—(A) used in a trade or business of the corporation, and (B) of a type with respect to which a deduction is allowable under section 167.’; 951A(d)(2) ‘Specified tangible property (A)In general: The term “specified tangible property” means, except as provided in subparagraph (B), any tangible property used in the production of tested income.’


38 This is the standard corporate tax rate of 21 percent provided by 26 U.S.C. § 11(b) less the 50 percent deduction of GILTI from tax permitted under 26 U.S.C. § 250(a)(1)(B).
December 2025 and is increased beginning in any taxable year starting 1 January 2026 to 13.125 percent.\textsuperscript{39}

### 3.4 Scope of the Global Intangible Low-Taxed Income Tax

Theoretically, the GILTI tax only applies to foreign income that is subject to an effective tax rate of less than 13.125 percent in its source country. The TCJA allows US corporate shareholders in a CFC to elect a foreign tax credit of 80 percent of their deemed paid foreign taxes by the CFC attributable to GILTI.\textsuperscript{40} The effective GILTI tax rate of 10.5 percent is 80 percent of 13.125 percent, so income subject to foreign taxes at a rate of 13.125 percent or more should not be subject to increased US tax amounts.\textsuperscript{41} However, under the foreign tax credit limitations, to the extent that expenses are allocable to GILTI, they may be ineligible for foreign tax credit and thus indirectly subject to US tax.\textsuperscript{42}

Furthermore, the foreign tax credit limitations were not revised under the TCJA and are thus silent to all issues related to the newly created GILTI category. Seemingly, the issue of disallowing credit for GILTI-allocable expenses would

\textsuperscript{42} Ibid. See 26 U.S.C. § 904.
exist regardless of the foreign tax rate and potentially result in consistent US taxation of certain global income regardless if it were sourced from a tax haven or a country with a higher effective tax rate than the new US rate.\textsuperscript{43} While this may lead to some worldwide taxation at current rates, this problem may be compounded when the rate constituting low-tax is increased to over 13 percent in 2026. This rate indicates that the GILTI tax will be calculated for income taxed at rates of less than 16.406 percent.\textsuperscript{44} If current trends towards reductions of corporate tax rate continues, US MNCs may face GILTI in a number of countries.\textsuperscript{45}

Depending on the circumstances, if there are expenses allocable to GILTI that preclude foreign tax credits, a corporation may face significant taxation on its worldwide income. For example, if a CFC’s net deemed tangible income return is small either from having a low qualified business asset investment or a large amount of interest expenses subtracted from the qualified business asset investment, then the net CFC tested income will be less affected when the net


\textsuperscript{44} 13.125 percent is approximately 80 percent of 16.406 percent.

deemed tangible income return is subtracted from it. This amount is the GILTI, regardless of how it was determined within the formula, and thus liable to tax.

Despite being discussed as global intangible low-taxed income, the calculation method prescribed under the statute tacitly encompasses all non-US income in low-tax jurisdictions, not merely income sourced from intangibles based in tax havens. While the formula for calculating GILTI requires the subtraction of certain tangible income amounts, the number against which it is subtracted contains income from more sources than intangibles alone. Considering the haste in which the TCJA was enacted by the legislature and the absence of any published official guidance or technical corrections, it is not apparent if the inclusion of non-intangible income was intentional.46 If the proclaimed intention of moving to a territorial tax system was genuine, then the broad calculation method of GILTI may be considered erroneous by omitting an explicit limitation to intangible-based income. If the move to a territorial tax system was a cynical ploy to garner support for a tax plan that effectively only reduced corporate tax rates and left the overall tax system intact, then the prescribed method for determining GILTI successfully renders idle much of the talk of change.

If the omission of language limiting the GILTI assessment to intangibles was a mistake, it will be difficult to correct without the intervention of the legislature. Given the long and troubled history of efforts to overhaul the US tax system, Congressional intervention is itself an apparently herculean task. If the US judiciary were to attempt to modify the language through a holding in a lawsuit, it would face a difficult task in explaining why deviating from the language of the statute is both permissible and necessary. The primary canon of statutory interpretation is that the words of the statute carry the meaning assigned to them by the statute and that all undefined terms carry their plain meaning so long as such interpretations do not produce absurd results. Because GILTI is a specifically defined term, the plain language assessment is inapplicable.47

Furthermore, while a definition of GILTI that incorporates tangible income is not an obvious definition, it is unlikely to be considered absurd by the court, especially since it seemingly does not create conflict with or violate a separate statute.48 As a result, a legal argument resting on the invalidity of the GILTI provision due to an ambiguity leading to an absurd result or statutory conflict is

47 Stenberg v. Carhart, 530 U.S. 914, 942 (2000) (US Supreme Court) ‘When a statute includes an explicit definition, we must follow that definition[.]’
48 Connecticut Nat. Bank v. Germain, 503 U.S. 249, 254 (1992) (US Supreme Court) ‘When the words of a statute are unambiguous, then, this first canon is also the last: “judicial inquiry is complete.”’
unlikely to prevail. However, if the GILTI assessment was intentionally written broadly to include non-intangible-based income in order to provide a de facto continuation of the worldwide tax system, it is likely to stand until more substantive changes in the IRC are enacted.

As a consequence of the provided definition for GILTI, three effects are apparent. First, its scope encompasses income from both intangible and tangible sources. Second, it potentially allows at least some continued US taxation on corporations’ worldwide income, despite the TCJA’s purported shift to a territorial system. Third, it is broadly harmonious with the OECD’s goals of discouraging profit shifting.

### 3.5 Global Intangible Low-Taxed Income Tax and the OECD

The calculation of GILTI and levying additional tax on income subject to relatively low rates is broadly consistent with the OECD’s BEPS project to curb abusive tax practices. A US MNC may shift its profits to a tax haven, but the incentive to do will be somewhat limited by the GILTI tax on income taxed at rates less than 13.125 percent. It may still be beneficial for US MNCs to shift their profits from a pure tax perspective because the GILTI tax is still substantially lower than the standard US corporate tax rate of 21 percent. However, with potential savings of less than seven percent overall, the cost of implementing a profit shifting plan and risking the potential for bad publicity
may discourage MNCs from doing so. While GILTI, when considered on its own, may be in line with BEPS, the EU has expressed concern that elements of the TCJA, particularly the Base Erosion Anti-Abuse Tax (a provision not discussed in this thesis) and FDII (especially when considered in conjunction with GILTI) act as an export incentive contrary to the OECD’s established norms. Section 4.5 of this thesis will return to this topic to more fully consider how these provisions ultimately align with BEPS.
4. Foreign-Derived Intangible Income

4.1 Introduction

In this chapter, there will be an overview of the TCJA’s newly created income category of FDII. This overview will provide some background on the FDII and why it was added into the IRC. This chapter will also address how the FDII is determined and how its prescribed calculation method expands its scope beyond intangible income. Finally, there will be an examination of how the FDII provision is perceived in the EU and how it compares with the policy goals of the OECD and the BEPS project. As a result of how intangible is defined for purposes of determining FDII, two effects become apparent. First, for tax categorization, it encompasses income from both tangible and intangible assets. Second, it permits deductions that can be construed as an export incentive.

4.2 Purpose of the Foreign-Derived Intangible Income Deduction

The FDII provision was intended as an incentive for US corporations with offshore intellectual property income to return assets to the United States.49

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Foreign derived intangible income (FDII) is not expressly defined within the TCJA. Instead, it is defined through a series of other defined terms as a type of special deduction available only to US corporate taxpayers. Despite lacking a direct explanation, it essentially acts as a special lower 13.125 percent (increasing to 16.406 percent for tax years starting 2026) tax rate on FDII rather than the new standard US corporate rate of 21 percent through the modification of deductions permitted to taxpayers on their foreign income.

### 4.3 Calculating Foreign-Derived Intangible Income

The TCJA does not expressly provide a formula for calculating FDII. Instead, it is calculated based on a chain of defined terms similar to determining GILTI. FDII is defined as the amount bearing the same ratio to the corporation’s deemed intangible income as the corporation’s foreign-derived deduction eligible income bears to its deduction eligible income.\(^{50}\) In other words, in order for a corporation to determine its FDII, it must first calculate its deduction eligible income, its foreign-derived deduction eligible income, and its deemed intangible income. Once the FDII is determined, a corporation can then determine its FDII deduction.

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\(^{50}\) 26 U.S.C. § 250(b)(1).

especially in technology and pharmaceutical sectors, often hold foreign rights for their IP in a company based in a low-tax country. ’
4.3.1 Calculating the Ratio of Foreign-Derived Deduction Eligible Income to Deduction Eligible Income

Foreign-derived deduction eligible income is defined as income derived from either property established as for foreign use that is sold by the taxpayer to a non-US person or from services provided by the taxpayer to any person or for any property located outside of the US.\(^{51}\)

Deduction eligible income is the amount of net gross income excluding subpart F income, GILTI, CFC dividends, financial services income, domestic oil and gas income, and foreign branch income, and after allocable deductions have been taken into account.\(^{52}\) Generally, this means that a US MNC has deduction eligible income if it has any taxable income.\(^{53}\)

\(^{51}\) 26 U.S.C. § 250(b)(4)
\(^{52}\) 26 U.S.C. § 250(b)(3)(A)
\(^{53}\) See Rödl & Partner, ‘37.5% Deduction for “Foreign-Derived Intangible Income” of Domestic Corporations’ (Roedl.net), roedl.net/us/tax_reform/key_business_tax_provisions/375_deduction_for_foreignDerived_intangible_income_of_domestic_corporations.html, accessed 7 May 2018. ‘A more detailed description of the steps necessary to compute the deduction follows:

1. Does the corporation have “deduction eligible income” under IRC § 250(b)(3)? Generally, this answer will be yes for any corporation that has taxable income.’
4.3.2 Calculating Deemed Intangible Income

A corporation’s deemed intangible income is the excess of its deduction eligible income (determined above) over its deemed tangible income return. The deemed tangible income return is determined the same way for FDII purposes as it is for GILTI: It is the excess (if any) of 10 percent of the shareholder’s aggregate qualified business asset investment over the amount of interest expense considered in determining the deductions properly allocable to gross income when determining the CFC’s tested income to the extent that the interest attributable to the expense is not considered in determining the shareholder’s net CFC tested income.\(^54\) Essentially, once the deduction eligible income has been determined, a corporation subtracts the deemed tangible income return from the deduction eligible income in order to calculate the deemed intangible income.

4.3.3 Determining the Foreign-Derived Intangible Income Deduction

Once a corporation has calculated its deduction eligible income, foreign-derived deduction eligible income, and deemed intangible income, it can then determine its FDII and its FDII deduction. To calculate the FDII, a corporation first divides its foreign-derived deduction eligible income by its deduction eligible income to

determine the ratio percentage. For example, if a corporation had $1 million USD in foreign-derived deduction eligible income and $2 million USD in deduction eligible income, it would divide $1 million by $2 million to determine a ratio of 1:2 or 50 percent. Next, the corporation calculates its deemed intangible income by taking its deduction eligible income and subtracting its deemed tangible income return. Returning to the example, if the corporation has a deemed tangible income return of $1 million USD, it would subtract this from its $2 million USD in deduction eligible income to determine a deemed intangible income figure of $1 million USD. Finally, a corporation calculates its FDII by multiplying the ratio percentage in the first step by its deemed intangible income. In our example, this is 50 percent x $1 million USD = $500 thousand USD in FDII. Between 1 January 2018 and 31 December 2025, a US MNC may deduct 37.5 percent of its FDII. For years after 2025, a US MNC may deduct 21.875 percent of its FDII.

4.4 Scope of the Foreign-Derived Intangible Income Deduction

Much like the GILTI calculations, the procedure for determining FDII considers income from tangible as well as intangible sources. Following the complex chain

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of defined terms reveals that FDII is determined from a figure explicitly containing gross income regardless of whether it was derived from tangible or intangible assets. While the FDII is calculated by subtracting certain tangible-based income, by its statutory definition it permits tangible asset income to be included in the final figure and thus makes some of a corporation’s tangible asset income eligible for deduction.

The FDII deduction is theoretically available for all US corporations that provide services or export goods abroad. As such, it cannot be considered a limited deduction for intangible asset income derived from foreign sources. Because of the way that FDII is calculated and the broad applicability of its deduction to US MNCs with foreign-derived income from any goods sold to or services provided to non-US persons, it goes beyond its intended role as an incentive for US MNCs to return their intellectual property to the US. Instead, it acts as a general goods and services export subsidy.


In light of the uncertain tax results of the TCJA, largely stemming from the complexity in applying many of its provisions, including the assessment of GILTI, FDII, and determining their effect when combined with the newly added GILTI tax and FDII deduction, the EU requested a review from the OECD Forum for Harmful Taxation for potential noncompliance with the standards provided in BEPS Action 5.  

Despite the FDII’s name, it is essentially all income derived from either the disposition of property or from services provided to non-US persons. Because the FDII deduction provision is newly added under the TCJA, there was no

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60 See 26 U.S.C. § 250(b). FDII is defined as the income from sales or services provided to non-US persons less certain amounts.
analogue under the old IRC. As a result, what is now known as FDII income would have been treated as any other income to the corporate taxpayer and taxed at the standard corporate rate of approximately 35-39 percent. But under the new system, the FDII deduction essentially creates a special lower tax rate on US MNCs export-based income.

A nation offering a lower tax rate on export income likely meets the definition of a prohibited subsidy under the World Trade Organization (WTO) rules. According to the WTO’s ASCM, a subsidy exists when there is a financial contribution (including tax credits) from the government for the benefit of the exporter. A subsidy is a prohibited subsidy when it is dependent on export performance. Under the WTO’s ASCM definition of prohibited subsidies, the FDII likely qualifies as one. Indeed, the finance ministers of finance ministers of the UK, Germany, France, Italy, and Spain expressed concern to the US Treasury Secretary that provisions within the TCJA such as the FDII violate international rules. Thus the manner in which FDII is defined led to a

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61 WTO, Agreement on Subsidies and Countervailing Measures (15 April 1994) LT/UR/A-1A/9 art 1.1(a)(1). Containing a definition for “subsidy”.
62 See ibid at art. 1.1(a)(1)(ii) and art. 1.1(b) A subsidy exists when the exporter receives a benefit of ‘government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)’.
63 See ibid at art. 3.1(a) Prohibited subsidies include ‘subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I’.
64 Francesco Guarascio, ‘EU ups pressure on U.S. over tax reform with second letter to Treasury Secretary’ Reuters (12 December 2017), https://www.reuters.com/article/us-usa-tax-eu/eu-ups-pressure-on-u-s-over-tax-
provision—ostensibly designed to encourage MNCs to base their intellectual property in the US—being earmarked for potential violations of WTO rules and exposing the US to retaliatory measures.

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reform-with-second-letter-to-treasury-secretary-idUSKBN1E62GE, accessed 12 January 2018. Reporting that the European Commission’s letter to U.S. Treasury Secretary Steven Mnuchin expressed concern that TCJA provisions such as the FDII ‘could result in export subsidies that are not allowed under WTO rules.’
5. Conclusion

The purpose of this thesis was to assess how three of the TCJA’s definitions for the word “intangible” affects the international taxation of US-based corporations for cross-border transactions and how these uses compare with international norms established by the OECD and WTO. First, examining the modified general statutory definition of “intangible property” to specifically include goodwill, workforce in place, and going-concern value closed a loophole permitting the exclusion of goodwill, ongoing concern, and workforce in place from the valuation of intangible property, and has brought the US in line with the OECD’s use of the phrase as used in its model convention. Second, “intangible”—as used in the new tax category of GILTI—supports the broad BEPS goal of curbing MNC abuse of low-tax jurisdictions, yet the definition of “intangible” within GILTI considers tangible property and minimizes the extent to which the US has shifted to a territorial system. Third, the meaning of “intangible income” as used in FDII—while nominally intended to induce US MNCs to return their intangible property to within the US—also includes tangible asset income and can be broadly applied in a manner that acts as export subsidy in contravention to the WTO’s ASCM.

Examining the calculation method for the GILTI tax reveals that the tax can also be applied to tangible asset-sourced income, seemingly at odds with the limited
scope implied by its name. While the GILTI tax should only apply to foreign income that is subject to an effective tax rate of less than 13.125 percent in its source country, under the foreign tax credit limitations and to the extent that expenses are allocable to GILTI, they may be ineligible for foreign tax credit and thus indirectly subject to US tax. Furthermore, the limitations on eligibility for foreign tax credit means that GILTI limits the extent to which the US is departing the old worldwide tax system. While potentially overly-burdensome in restricting deductions for global income, GILTI seems to be broadly in line with the BEPS goal towards reducing profit shifting.

As a result of how “intangible” is defined for purposes of determining FDII, two effects become apparent. First, determining FDII considers income from both tangible and intangible assets. Second, the prescribed FDII calculation permits tangible asset income to be included in the final deduction figure which is tantamount to the US government providing US corporations with a prohibited export subsidy. Because of the FDII calculation method, its deduction is theoretically available for all US corporate exports. As such, it greatly exceeds its intended scope as a limited deduction for intangible asset income derived from foreign sources. Instead of acting as an incentive for US MNCs to return their offshore intellectual property, it acts as a broad export subsidy and potentially runs afoul of the WTO’s rules.
In comparison with established international norms, the three different uses of “intangible” discussed in this thesis ultimately achieved mixed results. By changing its general-use definition, it closes a loophole that had previously been exploited by US corporations. By the definition of “intangible” used for calculating GILTI, it discourages profit shifting, putting the US broadly in compliance with BEPS as it moves to the more common territorial tax system. However, under the definition of “intangible” used in calculating FDII deductions, it helps establish an export subsidy specifically prohibited by the WTO.
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