GILTI and the GloBE

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Any comments or corrections would be gratefully received at Heydon.Wardell-Burrus@chch.ox.ac.uk

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GILTI and the GloBE

Oxford Centre for Business Taxation WP23/1

Heydon Wardell-Burrus – 2 February 2023

Abstract:

This paper considers the treatment of the GILTI regime under the GloBE Rules. First, it argues that the GILTI regime (in its current form) is most likely to be treated as a CFC Tax. It then sets out two detailed methodologies for properly allocating taxes under GILTI to individual CFCs in accordance with the GloBE Rules and Commentary. Under the 'deferential approach' the GloBE Rules would allocate all additional tax arising from the GILTI regime (including taxes arising from the 20% 'haircut' of foreign taxes and the foreign tax credit limitation rules). Under the 'assertive approach', the cross-jurisdictional allocation would be limited to where the GILTI regime was asserting 'secondary taxing rights'. The paper considers the impact of each of these options for the priority ordering rules between taxes as well as the incentives of states to impose the minimum tax. It argues that the preferential approach will largely depend upon whether or not the Inclusive Framework's objectives for the GloBE Rules include having the minimum tax being imposed by the jurisdiction of the Constituent Entity itself. Finally, the paper argues that both of these allocation mechanisms are complicated and, particularly in light of the possibility that the GILTI regime may be amended to bring it in line with the GloBE Rules, a simplified allocation rule may be considered appropriate by the Inclusive Framework as a transitional measure.

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Contents

1. Introduction 4
2. What type of tax is the GILTI Regime? 6
   - 2.1. The GILTI Regime as a qualified IIR 7
   - 2.2. A Transitional Rule 16
   - 2.3. The GILTI Regime as a CFC Tax Regime 17
3. Allocating GILTI as a CFC Tax Regime 18
   - 3.1. A Simplified Example 18
   - 3.2. The Methodology in the Commentary 21
   - 3.3. Losses in the Parent Jurisdiction 28
   - 3.4. SBIE 29
   - 3.5. High Tax Exclusion 32
   - 3.6. Expense Allocation 34
4. Should the GloBE Rules be deferential to the CFC Regime? 37
   - 4.1. Bifurcating CFC Regimes into Primary and Secondary Taxing Rights 37
   - 4.2. Priority Ordering Rules 40
   - 4.3. The QDMTT applies ahead of CFC Taxes 42
   - 4.4. CFC Taxes apply ahead of the QDMTT 44
   - 4.5. An Assertive Approach to allocating CFC Taxes 46
   - 4.6. Assertive Allocation Mechanism 48
5. A transitional allocation mechanism 49
6. Conclusion 51

Electronic copy available at: https://ssrn.com/abstract=4345960

1. Introduction

The interaction between the US tax system and the GloBE Rules has been a key ‘known unknown’ throughout the negotiation of Pillar Two. It was always possible that the US would not legislate the GloBE Rules (in particular, an IIR) directly into their domestic legislation. Accordingly, an important question has been whether the US would amend a key component of its international tax rules, namely the Global Intangible Low Taxation Income (GILTI) regime, to bring it into line with the outcomes of the GloBE Rules.[1] If this were achieved, the Inclusive Framework could have potentially been willing to treat the GILTI regime as ‘equivalent’ to an IIR. This would mean that the GloBE Rules would not generally apply to US headquartered MNEs.[2]

There was a clear attempt to amend the US tax rules by the Democratic Party in 2021 through the Build Back Better bill and early versions of the 2022 reconciliation bill. These attempts ultimately failed and, instead, the Inflation Reduction Act was passed in 2022. While the Inflation Reduction Act introduced another 15% minimum tax on US MNEs – the Corporate Alternative Minimum Tax (CAMT), it did not make the relevant amendments to the GILTI regime which would have the GILTI regime more closely into line with the IIR.

In the mid-term elections in November 2021, the Democratic Party lost control of the House of Representatives. Now, any legislation to amend the US tax system before the next election in 2024 will (barring exceptional circumstances) require support from at least some Republicans. In an era of partisanship, only the very optimistic would assume that the US would be able to pass legislation through Congress which would align the GILTI regime with the GloBE Rules prior to the 2024 election. As the GloBE Rules are expected to be legislated in 2023,[3] the question of how to treat the existing US tax system cannot be put off much longer. The Inclusive Framework will need to address the interactions between the US tax system and the GloBE Rules before they can begin to apply the rules.

This article proceeds in six parts. In Part 2, it addresses whether the GILTI regime should be treated as a qualified IIR with respect to two key criteria – (1) whether such treatment would give US MNEs an

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[1] See OECD (2020), ‘Tax Challenges Arising from Digitalisation - Report on Pillar Two Blueprint’, October 2020, OECD, Paris (‘Pillar Two Blueprint’), Section 1.3.

[2] There are several potentially important exceptions to this rule. For instance, another country could apply the IIR to a ‘partially owned parent entity’ (or POPE) under Art. 2.1.4 of the GloBE Model Rules. See OECD (2021), ‘Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two)’, 20 December 2021, OECD, Paris (‘GloBE Model Rules’).

[3] Though they may not be operational until 2024 at the earliest.

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advantage compared to MNEs headquartered in other jurisdictions, and (2) whether it would undermine the incentives for low tax jurisdictions to raise their tax rates to the minimum created under the GloBE Rules. While acknowledging that it is ultimately a question of politics and negotiation for the Inclusive Framework to decide, there are good reasons for the GILTI regime not be treated as a qualified IIR in its current form.

In Part 3, the article sets out a detailed allocation methodology for allocating GILTI to foreign subsidiaries. This allocation methodology is based upon the GloBE Commentary but sets out a mechanism for taking into account the CFC-by-CFC allocation of both foreign tax credits and the allocation of expenses. While a pro rata allocation mechanism would be simpler, it would arguably produce outcomes which are inconsistent with the proper allocation of the CFC taxes as described in the Commentary. This allocation mechanism is 'deferential' to the CFC regime and seeks to allocate GILTI taxes in accordance with the design of the US GILTI regime.

In Part 4, the article raises the question of whether the GloBE Rules should simply accept any CFC Taxes as applicable or whether the GloBE Rules have a more active role to play in determining the priority order between various types of taxes. The paper acknowledges that on one view, the GloBE Rules play no such role and merely apply as provisions imposing a tax of last resort (the deferential approach). However, the paper takes seriously an alternative view that the GloBE Rules should play a greater role in policing the priority ordering rule between taxes (an assertive approach). It argues that the Inclusive Framework could consider an assertive approach under which CFC taxes were only allocated to the extent that the CFC regime was exercising 'secondary taxing rights' (that is, the CFC regime allows the full use of underlying taxes paid to the CFC state on the included income). This part also sets out a methodology which could be adopted by the Inclusive Framework to achieve this result.

In Part 5, the article acknowledges that both the allocation mechanisms for both the deferential and assertive approaches are complicated and may take time to implement. Accordingly, this section addresses the possibility of a simplified transitional regime which would address the allocation of GILTI.

Ultimately, the paper concludes that while the pushdown of US CFC Taxes may appear to be a minor technical problem, it is in fact of crucial significance in the structure of the tax system under the GloBE Rules. Its impacts ought to be taken seriously and considered carefully as part of the Inclusive Framework negotiating process.

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2. What type of tax is the GILTI regime?

The GILTI regime is complicated. However, simplifying greatly, it imposes an immediate top-up tax on a US shareholder if its foreign subsidiaries, taken together, have 'active' income which is subject to tax at less than a 13.125% rate.[4] There is a reasonable claim that the US unilaterally adopted a 'global minimum tax' which applies only to US shareholders as part of its 2017 tax reforms. The GILTI regime is a clear predecessor of the GloBE Rules' 'Income Inclusion Rule' (IIR). Despite this, there are several important differences between the two taxes. These discrepancies can produce important differences in the outcomes and incentives created by the regimes. A more detailed account of the GILTI regime applied to an example is in Section 3.1.

This section addresses two key questions. First, what type of tax is the GILTI regime under the GloBE Rules? That is, should it be treated as an IIR, a CFC Tax Regime or a non-Covered Tax? Second, if the GILTI regime is treated as a 'CFC Tax Regime' (which the author considers the most likely outcome), how much is the relevant CFC Tax and how should it be allocated between subsidiary jurisdictions? These questions are of fundamental importance because they determine the interaction between the US 'global minimum tax' (which applies to a significant portion of global foreign direct investment) and the negotiated GloBE Rules. As argued in the final part of this section, the allocation mechanism fundamentally impacts the institutional mechanism for regulating tax competition.

There are effectively three potential ways to treat the GILTI regime under the GloBE Rules. The first is as 'equivalent' to the IIR. This would generally be the most beneficial to MNEs subject to the GILTI regime. If the GILTI regime were treated as equivalent to the IIR, then it would replace the GloBE Rules with respect to MNEs which are headquartered in the US and therefore subject to the GILTI regime.[5] The second possibility is that the GILTI regime would be treated as a 'CFC Tax Regime'. This seems the most likely as the GILTI regime is different from the IIR in important ways and it is clearly a regime which imposes taxation on a parent with respect to its foreign controlled subsidiaries. Quite simply, the GILTI regime falls within the definition of a CFC Tax Regime contained in the GloBE Rules. This should therefore be considered the default position and other treatment for the GILTI regime by the Inclusive Framework would be an agreed deviation from the wording of the Model Rules. The third, and clearly most radical,

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[4] See further description in Section 3.1.

[5] It is important to note that even if this occurred, the MNE would still effectively be 'subject' to the GloBE Rules insofar as the underlying jurisdictions in which it operated had adopted a 'Qualified Domestic Minimum Top-up Tax' (QDMTT) or if the IIR applied at an intermediate level through the Partially Owned Parent Entity (POPE) Rules.

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option would be to treat the GILTI regime as a 'non-Covered Tax'. This would make US MNEs subject to both the GloBE top-up tax and the GILTI regime. It would effectively put the onus on the US to relieve the economic 'double taxation' which would otherwise be produced by the regime. We should expect this outcome to be strongly resisted by the US. It is difficult to imagine this being adopted unless it was (a) a part of a 'hardball' bargaining strategy to push the US to align GILTI to the GloBE Rules or (b) in response to the US refusing to credit the QDMTT if the Inclusive Framework agreed that the QDMTT ought to apply before CFC Taxes.

2.1. The GILTI Regime as a qualified IIR

The GloBE Rules appear to leave significant latitude for the Inclusive Framework to determine whether or not a regime is a 'qualified IIR'. Qualified IIR is defined in the GloBE Rules to be a set of rules that are 'equivalent' to the rules contained in Articles 2.1 to 2.3 of the GloBE Rules.[6] To be a qualified IIR, the regime must be 'implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and the Commentary'.[7] The definition is inherently vague. It is not at all clear how similar a regime needs to be in order to be considered 'equivalent'. It is also not clear at what level of specificity one ought to consider the 'outcomes' with which the regime must be consistent.

This uncertainty was likely considered to be 'a feature, not a bug' of the GloBE Model Rules design. Whether or not any particular regime (but most importantly, the GILTI regime) would be considered sufficiently similar may be a matter of political agreement amongst the Inclusive Framework rather than purely a matter of interpreting the GloBE Rules. Nevertheless, it is worth considering how similar the GloBE Rules and the GILTI regime are in terms of their design and effects. If there were no substantial differences, there would be significant grounds for treating the GILTI regime as 'equivalent' to a qualified IIR.

The basic structure of the GloBE Rules is that they calculate the effective tax rate (ETR) for a multinational enterprise (MNE) in each jurisdiction in which it operates based upon a newly agreed tax base. The new tax base (Adjusted GloBE Income) is based upon accounting income with a set of agreed amendments.[8] The ETR numerator includes 'Covered Taxes' which are generally profit-based taxes on the Adjusted GloBE Income.[9] The relevant Covered Taxes do not have to be paid to the jurisdiction of the Constituent Entity.

[6] See GloBE Model Rules, above n 2, Art. 10.1.
[7] See GloBE Model Rules, above n 2, Art. 10.1.
[8] These are set out in GloBE Model Rules, above n 2, Art. 3.
[9] GloBE Model Rules, above n 2, Art. 4.2.

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There is an allocation mechanism for 'cross-jurisdictional taxes' (that is, taxes paid to one jurisdiction which are with respect to income allocated under the GloBE Rules to another jurisdiction).[10] If that ETR is below 15%, a top-up tax is imposed to increase the tax rate to 15% but only in relation to the 'excess profit' in the jurisdiction. The excess profit is the amount of profit above the substance-based income exclusion (SBIE), which is a formulaic return on the tangible assets and payroll expenses in the jurisdiction.[11] In other words, the SBIE is a 'carve-out' such that the top-up tax does not apply to a percentage return on the 'substance' in the jurisdiction. 'Substance' under the GloBE Rules includes both depreciable tangible property and payroll costs for the business.[12]

If there is a top-up tax amount due, there are three ways it can be collected. First, it can be collected by the undertaxed jurisdiction itself through a 'qualified domestic minimum top-up tax' (QDMTT). Second, if the undertaxed jurisdiction does not choose to collect the tax itself, it will be imposed on a parent entity within the group (usually the ultimate parent entity) under the IIR (Income Inclusion Rule). The IIR essentially acts as a type of CFC tax which imposes a top-up tax to the agreed amount. Finally, if there is no applicable IIR, then the top-up tax amount will be imposed under a 'back-up rule' called the UTPR.[13] This would impose the tax on other related entities within the consolidated group.

The key question then becomes whether the GILTI regime is sufficiently similar to the IIR under the GloBE Rules. As noted above, the definition of 'qualified IIR' required the tax to be administered and implemented in a way that is consistent with the *outcomes* of the GloBE Rules. While 'outcomes' can be defined at different levels of abstraction, there are two key considerations one could expect to be salient to the Inclusive Framework. First, would treating the GILTI rules as a qualified IIR give US MNEs an unfair advantage such that they would be subject to less total tax than if they had been subjected to the 'regular' IIR? Second, and potentially contested, is whether treating the GILTI regime as a qualified IIR would reduce the incentives for undertaxed jurisdictions to raise their tax rates to the minimum rate? This second objective should be considered particularly important to countries which consider themselves constrained in raising their tax rates due to tax competition.

[10] GloBE Model Rules, above n 2, Art. 4.3.
[11] GloBE Model Rules, above n 2, Art. 5.2.
[12] GloBE Model Rules, above n 2, Art. 5.3.
[13] This was previously called the Undertaxed Payments Rule but following its redesign as announced in the Model Rules of December 2021 has been referred to as the Undertaxed Profits Rule. However, the GloBE Rules do not define the acronym UTPR.

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The difference between these two considerations is driven by whether one is only concerned about the MNE being subject to the minimum level of taxation (the first objective) or whether one is also concerned about the undertaxed jurisdiction (that is, the jurisdiction with the constituent entities themselves) having the proper incentives to raise their rates to the minimum. If one only cares about the former, then one does not have a strong preference with respect to which jurisdiction gets the revenue; the aim is only to make sure the MNE pays enough tax. If we are also concerned about ensuring that the jurisdiction which was allocated the profit under transfer pricing rules gets the revenue (that is, the jurisdiction of the Constituent Entity), then we should be concerned with the latter objective.[14] The latter objective is likely to be of greater importance to capital importing countries than capital exporting countries. This is because capital importing countries are more likely to be benefited from the revenue going to the state of the constituent entities.[15]

If one accepts both of the above objectives, then whether or not the GILTI regime achieves the same outcomes as the GloBE Rules should involve considering whether it would (a) systematically advantage US MNEs;[16] and/or (b) significantly reduce the incentive for low tax states to raise their domestic corporate taxes to the minimum rate. Accordingly, the differences in the two regimes should be analysed with respect to their impact on these two questions.

The GILTI regime has several key differences from the IIR.[17] First, it does not calculate the relevant ETR on a jurisdiction-by-jurisdiction basis. The GILTI regime allows for the 'blending' of the relevant GILTI income of CFCs between jurisdictions outside the US. For instance, the profits of high-tax jurisdictions and low-tax jurisdictions are blended together and then the relevant tax is offset against a single pool of foreign

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[14] For a further analysis, see Michael Devereux, John Vella and Heydon Wardell-Burrus, 'Pillar 2's Impact on Tax Competition', *World Tax Journal* (forthcoming), Section 2.2 (Working Paper available on SSRN at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4203395); C.f. Johannes Becker and Joachim Englisch, 'GloBE Minimum Taxation: Calculating the Local ETR with Carve-outs', Kluwer International Tax Blog, 17 December 2021 (http://kluwertaxblog.com/2021/12/17/globe-minimum-taxation-calculating-the-local-etr-with-carve-outs/).
Becker and Englisch claim that the "GloBE proposal is about stabilizing the tax payments made by multinational firms, i.e. introducing a lower bound to the firm's total ETRs. Thus, in effect, its very purpose is to reduce the effectiveness of local tax rate cuts. Therefore, evaluating different models of ETR calculation with regard to their incentives to change local tax rates is of little relevance."

[15] Of course, some countries (in particular, large capital exporting countries) may not be particularly concerned as to whether the rules create sufficient incentives for low-taxed jurisdictions to raise their tax rates to the minimum. These states may only be concerned with the total amount of tax on the MNE (and less concerned by which jurisdiction receives the tax).

[16] This would clearly not be an analysis with respect to each possible individual case. It would be enough if sometimes US MNEs were advantaged and sometimes they were disadvantaged, as long as the treatment on the whole was roughly similar.

[17] For clarity, I do not suggest that the differences addressed in this article are an exhaustive list.

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tax credits. This effectively produces one 'globally blended' tax rate.[18] Furthermore, domestic losses can also be used to offset the liability which would otherwise arise with respect to foreign income. This means that the GILTI regime does not ensure that US MNEs pay a minimum level of tax in every jurisdiction in which they operate.[19] Despite having undertaxed excess profits in one jurisdiction, a US MNE could potentially avoid any top-up tax if there is sufficient highly taxed income in another jurisdiction.[20]

Second, the GILTI regime does not apply the GloBE base which would apply under the IIR. Instead, it applies the US tax law base.[21] While these tax bases are different, this may not be considered by the Inclusive Framework to be a substantial obstacle to giving the GILTI regime equivalent treatment. The GloBE Rules themselves do not apply a perfectly consistent tax base. In most cases, the relevant MNE will use its existing accounting standards as a starting point (which would then be modified in accordance with the GloBE Rules). As the applicable accounting rules can vary, there is already variation in the GloBE tax base.[22] Accordingly, mere variation is unlikely to be perceived as a significant problem. The integrity concern with respect to allowing US MNE's to be subject to the GILTI regime is that it would apply a significantly *narrower* base.

As the GILTI Rules generally rely upon the 'regular' US corporate tax base, the concern would need to be that the US tax base is much narrower. While the GloBE tax base *starts* with accounting concepts, this base is modified to create the tax base in line with two criteria - commonality and materiality.[23] In other words, the GloBE Rules created a tax base by starting with existing accounting standards and then modifying the outcomes where (a) lots of countries have adopted a tax treatment which differs from the accounting treatment and (b) where the outcome is significant. Accordingly, the concern must be that the US tax base (as applied under GILTI) has rules which narrow the tax base in a way which was not taken

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[18] The term 'globally blended' is slightly misleading because it excludes the US as a jurisdiction. That is, it only blends together the income of the foreign subsidiaries of a US MNE.

[19] Counterintuitively, due to the interaction between the substance-based carve-out and the calculation of effective tax rates, blending two investments together is not necessarily to an MNEs advantage. There are cases where blending two investments together makes them subject to more top-up tax than if they were each subject to the top-up tax separately. See further Heydon Wardell-Burrus, 'Tax Planning under the GloBE Rules', 2022(5) *British Tax Review* 623*,* 646.

[20] Whether or not this would actually occur depends upon a variety of factors, most importantly, the foreign tax credit limitation (see below). To be clear, the claim is not that US MNEs will always be able to blend all high tax income with low tax income with no restrictions.

[21] See further Mindy Herzfeld, 'Do GILTI + BEAT + BMT = GloBE?', 50(12) *Intertax* 1.

[22] This was a necessary step to avoid the Inclusive Framework needing to build a tax base from scratch which started from questions such as 'what is income?'. The use of accounting profit allowed a 'short-cut' so that the Inclusive Framework could focus on key variations from an underlying concept of accounting profit.

[23] This rationale was set out in the October 2020 Blueprint. See Pillar Two Blueprint, above n 1, paragraph [178].

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into account under the GloBE Rules (and therefore was considered not to meet the requirements of commonality and materiality). While it is not at all clear that the US has a strong incentive to set its domestic tax base principles to create a narrow base, there could be specific rules which are important and could be a real concern to Inclusive Framework members.[24] For example, the amortization of goodwill and certain intangibles.[25]

Third, the GILTI regime does not apply a 15% minimum tax rate to that base. Putting aside (for now) the issue of expense allocation and the accompanying foreign tax credit limitation, where the GILTI regime imposes additional taxation at all, it will achieves a total tax rate on the blended foreign profits of between 10.5% and 13.125% prior to 2026.[26] Under currently legislated law, it would rise from 1 January 2026.[27] It is important to recognize that these 'headline figures' are generally misleading. In many cases, we would expect a higher level of total taxation which would be produced as a result of the US expense allocation rules. The US tax regime effectively caps the allowed foreign tax credits based upon the allocation of expenses to the GILTI income.[28] Where this cap applies, the US MNE is not able to use all of its foreign tax credits. Formally, this increases the US taxes arising as a result of the MNE's GILTI income. However, whether such additional tax is properly attributable to the underlying CFC jurisdictions could be subject to dispute (this is addressed Part 4 below).

For present purposes, if the additional taxes paid by the US parent arising due to expense allocation are considered to be allocable CFC Taxes, then many US MNEs are likely to have a higher effective tax rate on foreign GILTI income than 15%. Of course, even if the headline figures are misleading, there may be a

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[24] Note that this puts to one side narrowing the base through the 50% discount for GILTI Income (the 'section 250 deduction' (US Internal Revenue Code (IRC) §250). This is addressed below.

[25] The GloBE tax base does not allow for the amortization of good will or intangibles. C.f. US IRC § 197.

[26] Simplifying greatly, the GILTI regime operates by including a proportionate share of all of the including the active income of a US Shareholder's subsidiaries into the shareholder's taxable income. The regime then grants the shareholder a 'section 250 deduction' which is equal to half that inclusion amount. The net income is subject to tax at 21% (which is an effective rate of 10.5% on the total amount). However, the US Shareholder is also entitled to a tax credit equal to 80% of the foreign taxes paid on that amount. Accordingly, if the average tax rate was subject to tax at a rate of 13.125%, then there will be total allowed tax credits of 10.5% (this is 80% of 13.125%). This means that this income would be subject to tax at a rate between 10.5% and 13.125% depending upon the amount of foreign taxes. This simplified version does not take into account several key features including (a) a substance-based carve out called Net Deemed Tangible Income Return (NDTIR) and (b) the possibility of a cap on foreign tax credits imposed as a result of expense allocation. These issues are addressed below.

[27] From 1 January 2026, the figure is increased to 13.125% as a result of a rate change with respect to the section 250 deduction. From 1 January 2026, the section 250 deduction for GILTI Income is reduced from 50% to 37.5%.

[28] However, whether or not these additional costs should be considered as properly allocated to the underlying jurisdiction is a separate question which is addressed in further detail below. See Part 3 below.

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significant political tension in treating the GILTI regime as equivalent where it can (even theoretically) produce an ETR of 4.5% lower than the initially and 1.875% below the minimum after 1 January 2026.[29]

Fourth, there is a difference between the substance-based carve-outs offered under GILTI and the GloBE Rules. The GILTI carve-out is called NDTIR (Net Deemed Tangible Income Return) and is a formulaic carve-out which is equal to 10% of the QBAI (Qualified Business Asset Investment) of the relevant CFC.[30] This is effectively the value of tangible assets (and does not include any element of payroll expense). The GloBE Rules rely upon SBIE (substance-based income exclusion) which is a formulaic return on both the carrying value of the tangible assets and the payroll expenditure for the jurisdiction.[31] The percentage return on the tangible assets and payroll reduces from 8% and 10% respectively to 5% over a 10-year period.[32] When compared to each other, the key difference is that the GILTI regime does not allow any carve-out for the 'substance' of having employees in a jurisdiction while the GloBE Rules do.

Fifth, the GILTI regime does not have an equivalent of the QDMTT. The GloBE Rules only require a 15% minimum tax to be paid with respect to the *Excess Profit* in a jurisdiction. This works by calculating the ETR for the jurisdiction based on all of the profit (Excess Profit and 'substance-based income exclusion' (SBIE)). However, only the Excess Profit is subject to a top-up tax which would raise its rate to 15%. The GloBE Rules allow the undertaxed jurisdiction to collect this amount itself through a 'qualified domestic minimum top-up tax' (QDMTT). While regular corporate income tax is considered to count towards all of the profit in the jurisdiction, amounts of QDMTT are considered to be taxes only on the Excess Profit. Accordingly, the QDMTT directly reduces the amount of top-up tax which would have otherwise been imposed under the IIR or UTPR on a dollar-for-dollar basis and is not 'diluted' by being effectively allocated between the Excess Profit and the SBIE. The GILTI regime has no equivalent to the QDMTT. Assuming that the US grants a foreign tax credit for the QDMTT at all,[33] it would not directly reduce the amount of GILTI tax which would otherwise fall due.[34] Any such tax would still be allocated between the GILTI Income

[29] Of course, this outcome could otherwise be achieved anyway by differences in the GloBE base and the GILTI base (as noted above). These figures are given by (15% - 10.5%) and (15% - 13.125%) respectively.
[30] See IRC § 951A(b)(2).
[31] See GloBE Model Rules, above n 2, Art. 5.3.
[32] See GloBE Model Rules, above n 2, Art. 9.2.
[33] See discussion in Heydon Wardell-Burrus, 'Should a Foreign Tax Credit be given for QDMTT?', *Tax Notes International*, 27 June 2022, 1649.
[34] That is, it would not reduce the GILTI liability on a dollar-for-dollar basis.

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inclusion and the NDTIR under the GILTI regime. In other words, the GILTI regime would 'dilute' the QDMTT rather than allowing it to directly reduce the top-up tax as occurs under the GloBE Rules.[35]

Ultimately, whether or not the Inclusive Framework is willing to treat the GILTI Rules as equivalent of the IIR is likely to be resolved as a political question. However, informing that decision will be the two criteria raised above. First, would it put MNEs that are subject to the 'regular' IIR at a disadvantage to US MNEs (which would only be subject to the GILTI regime)? Second, would it create the required incentives to ensure that the minimum tax was collected in the jurisdiction of the constituent entities? Consider a simplified example.

Example

MNE A is headquartered in the US and is subject to the GILTI regime. MNE B is headquartered in a country which has adopted the IIR. Both MNE A and MNE B have subsidiaries in states X and Y, each earning $1000 in profit and without any substance.[36] State X has an effective tax rate of 30% and imposes $300 taxation on the subsidiaries of MNE A and MNE B. State Y has no corporate tax at all. MNE A is headquartered in the US and subject to the GILTI regime. On these simplified facts, there is a GILTI inclusion of $2000, a section 250 deduction of $1000 and a prima facie tax liability of $210. However, MNE A can use the foreign tax credits which arise from taxes paid in State X ($300) to offset this liability.[37] As a result, despite the fact that there is no tax paid in State Y, there is no additional tax under the GILTI regime (again, acknowledging that these are highly simplified facts).

MNE B on the other hand is subject to the IIR and the GloBE Rules. It cannot blend the high tax income in State X with the low tax income in State Y. Accordingly, it would be subject to a $150 top-up tax imposed under the IIR. The result is that if the GILTI regime were treated as equivalent to the GloBE Rules, the US MNE would avoid top-up tax while the MNE subject to the IIR would have to pay an additional $150 in taxes. This is despite the fact that the two MNEs have identical operations in the same jurisdictions. It is

[35] The GILTI regime subtracts the amount of NDTIR from the Globe Inclusion and reduces the included foreign tax credits proportionately. In other words, it aims to only include the 'residual profit' (after the carve-out amount) in the US shareholder's tax base and accordingly disallows tax credits which have been paid with respect to the carve-out amount (which is not included in the parent's tax base). However, the regime does not attempt to 'trace' the relevant taxes to whether they were with respect to the 'residual profit' or the NDTIR amount. The taxes are simply allocated in proportion.

[36] Assume entirely for simplicity that MNE A has no US expenses which are allocated to its GILTI Income. I acknowledge that this is a non-representative assumption. The importance of expense allocation is addressed below in Section 4.1.

[37] Though these tax credits could not be used to offset any taxes on domestic profits.

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easy to see why countries which have adopted the full IIR would be concerned that their MNEs would be disadvantaged compared to US MNEs.

It is important to note that this simplified example only shows how the GILTI regime can advantage US MNEs. It does not show the ways in which it can disadvantage the MNE – in particular, the impact of expense allocation rules. These are addressed below in further detail. It is certainly true that many MNEs may be in an 'excess foreign tax credit position' such that the GILTI regime does impose an additional tax burden, even if their globally blended CFC Income is subject to tax above a 15% rate. Accordingly, US MNEs are likely to be less advantaged by global blending than the above example suggests. One can also construct examples where the GILTI regime would impose greater taxation than would be imposed under the GloBE Rules.

It is very difficult to predict whether, on the whole, the US GILTI regime would produce a better or worse outcome for US MNEs than being subject to only the GloBE Rules in light of dynamic behaviour. However, for present purposes, it is important to note two things. First, there are clear ways in which the GILTI regime could advantage US MNEs compared to MNEs subject to the GloBE Rules if the GILTI regime were treated as equivalent to the IIR. Second, US MNE's clearly cannot be advantaged if the GloBE Rules were to apply on top of the GILTI regime (as a CFC Tax).

The example so far has only addressed the first of the two key 'outcomes' – whether or not US MNEs would be advantaged compared to non-US MNEs in an undertaxed jurisdiction. The second key aspect is the incentives created by the GloBE Rules for low tax jurisdictions to raise their corporate tax rates. If the US GILTI regime generally 'switches off' the GloBE rules (that is, is treated as an IIR) and nevertheless incentivises foreign jurisdictions to offer tax rates below the GloBE minimum,[38] then the treating the GILTI regime as equivalent to an IIR would undermine an important (but potentially contested) outcome produced by the GloBE Rules.[39] This issue is particularly important because the US is such an important source of foreign direct investment for many jurisdictions.

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[38] Subject to a number of important caveats, this 'floor' would be a zero Corporate Income Tax adopted with a QDMTT. This would impose a 'floor' of 15% of the Excess Profit in the jurisdiction. This argument is made in Michael Devereux, John Vella, and Heydon Wardell-Burrus 'Pillar 2: Rule Order, Incentives, and Tax Competition' *Oxford University Centre for Business Taxation Policy Brief*, 14 January 2022 (see https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4009002) and subsequently elaborated in Devereux, Vella and Wardell-Burrus, 'Pillar 2's Impact on Tax Competition', above n 14.

[39] It is important to address this question practically. The question is not whether there are any circumstances in which an MNE could gain an advantage by being subject to the GILTI regime as opposed to the GloBE Rules. This is far too high a burden. The real question is whether the regime creates sufficient incentives for the underlying

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The key point is that *even if* the GILTI regime produces an approximately equivalent level of tax to the GloBE Rules (due to expense allocation, in particular), it may be inconsistent with the 'outcomes' required under the GloBE Rules if it undermines the incentive for a low tax state to raise their tax rates to the minimum. If US MNEs are only subject to a similar level of additional tax because of the expense allocation rules, this result seems likely. Simplifying significantly, the expense allocation provisions can increase US tax by limiting the available foreign tax credits which can be used to offset the tax liability on the GILTI income which would otherwise would have been imposed. Where this limitation applies, the taxpayer is in an 'excess foreign tax credit position'. In such a case, the taxpayer has more foreign tax credits than are allowed to be used to reduce their US tax liability. This limitation rule may increase the amount of tax paid by the US MNE to a roughly comparable level to that imposed under the GloBE Rules. However, in such a case, *every additional dollar of foreign tax paid by a CFC is an additional dollar of total tax to the MNE*.

This is arguably inconsistent with the second objective because it undermines the 'floor' logic created by the GloBE Rules which would stop a 'race to the bottom'. In order to meet the second objective, the undertaxed jurisdiction (that is, the jurisdiction with the relevant constituent entities) should have no reason ***not*** to impose the minimum level of tax. The low tax jurisdiction might as well impose tax on the relevant profit because, if it does not then another jurisdiction will impose the tax anyway. In such cases, the low tax jurisdiction imposing the minimum tax does not increase the total amount of tax paid by the MNE. Accordingly, there are proper incentives for the undertaxed jurisdictions to raise their rates to the minimum because it does not change the total tax paid by the MNE.

If a US MNE is in an excess foreign tax credit position, this logic does not apply. Each additional dollar of tax paid in the low tax jurisdiction is an additional dollar of total tax paid by the MNE. The additional US taxation imposed under the GILTI regime is a result of the foreign tax credit limitation. Accordingly, any additional tax paid in the low tax jurisdiction does not reduce the amount of GILTI in the way that it would reduce the amount of IIR. If a low tax state can continue to attract foreign direct investment from US

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jurisdictions to raise their rates that they are likely to do so in practice. All undertaxed jurisdictions are facing a trade-off between raising additional revenue and attracting foreign direct investment. If the GILTI regime were sufficiently similar that there was no practical difference in the incentives to keep a low tax rate in the jurisdiction with FDI subject to GILTI regime as opposed the GloBE Rules, that should be sufficient. Beyond that point, there is a question of how much 'slippage' should be allowed for political reasons.

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MNEs in excess foreign tax credit positions, then there will be a continued incentive for these jurisdictions to lower their tax rates below the minimum. The 'race to the bottom' could continue for low tax states.[40]

If we take the second objective seriously, then even if US MNEs would pay a roughly equivalent amount of additional tax under the GILTI regime (generally due to expense allocation), the important incentive to stop the 'race to the bottom' would arguably be undermined by treating the GILTI regime as equivalent to the GloBE Rules. Accordingly, there are good reasons to suspect that the Inclusive Framework may be unwilling to treat the current GILTI regime as equivalent to the IIR.

2.2. A Transitional Rule?

If the Inclusive Framework is unwilling to accept the GILTI regime as a qualified IIR on a permanent basis, they could consider treating it as equivalent on a transitional basis. For instance, there could be an agreement to treat the GILTI regime as equivalent to the IIR until 2026 in order to give the US an opportunity to pass amending legislation following the election in 2024.[41] In this context, it is worth noting that the Inclusive Framework released a consultation paper on 'Safe Harbours and Penalty Relief' in December 2022. The consultation document did not include a transitional regime which would fundamentally switch off the GloBE Rules with respect to the subsidiaries of US MNEs.[42]

If such a transitional measure were adopted, it would be important to consider the treatment of the GILTI regime after the transitional period came to an end. The Inclusive Framework could attempt to create a strong incentive for the US to amend the GILTI regime by treating GILTI as a non-Covered tax after the expiry of the transitional period. This would, absent a change of US law, be likely to produce effective economic 'double taxation' for US MNEs unless the US tax regime were altered to prevent this outcome.[43] US MNEs would effectively be subject to top-up tax under both the GloBE Regime and the GILTI regime.

[40] It should be noted that some commentators have argued that developing countries should be able to continue engaging in 'real' tax competition (as opposed to 'virtual' tax competition) – see, for example, Afton Titus, 'Global Minimum Corporate Tax: A Death Knell for African Country Tax Policies?', 50(5) *Intertax* 414, 415.

[41] The legislated expiration of a variety of US Tax provisions inserted under the TCJA is anticipated to produce a tax bill in Congress in 2025. This may provide an opportunity revisit the key GILTI provisions.

[42] The document outlined a transitional country-by-country reporting safe harbour which would apply to the initial years of the GloBE Rules – 2023 to 2026. This would provide a safe harbour where there was a 'Simplified ETR' of above 15% (for financial years beginning in 2023 and 2024), 16% (2025) and 17% (2026). This would be based upon 'Simplified Covered Taxes' that includes the income tax expense reported in the qualified financial statements. The consultation document states that the transition rule 'does not require any adjustments under GloBE (such as allocation of CFC or Main Entity taxes)'.

[43] Double taxation could be avoided by the US granting foreign tax credits for GloBE taxes. This could potentially be achieved through Treasury regulations rather than legislative amendments. Of course, this outcome could still be perceived as the rest of the world unfairly taxing US MNEs inconsistently with the proper treatment of the GILTI regime as a CFC Rule.

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However, such 'hardball' negotiating tactics could backfire and be perceived as a threat (either by the US administration or US Congress which would ultimately need to pass any legislative amendments). Such an approach may also be considered to be inconsistent with the constructive approach which has been adopted by the parties to the multinational negotiations which has been adopted so far.

Combining transitional relief (that is, treating as a qualified IIR on a temporary basis) and committing not to treat an unamended GILTI as a Covered Tax after the transition period would be a 'carrot and stick' approach. It would effectively give the US a temporary benefit combined with a strong incentive to amend the GILTI regime. Nevertheless, treating GILTI as a non-Covered Tax is likely to be viewed as a particularly aggressive 'stick'. A middle position would simply be to adopt the transitional relief without making any commitment as to whether or not GILTI would be treated as a Covered Tax after the end of the transitional period. In such a case, the uncertainty could potentially be sufficient to produce the desired change without being perceived as a direct threat.

2.3. The GILTI regime as a CFC Tax Regime

If the GILTI regime is not treated as a qualified IIR (either temporarily or permanently), it is most likely to be considered a CFC Tax under Model Rules.[44] A CFC Tax Regime is defined as:

> *a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign entity (the controlled foreign company or CFC) is subject to current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder.*[45]

The GILTI regime clearly meets this definition and, absent any agreement to the contrary, should be treated as such under the GloBE Rules. Accordingly, the 'default expectation' should be that the GILTI regime would be a CFC Tax Regime unless the Inclusive Framework comes to a different agreement (as outlined above).[46]

[44] Other commentators have also reached this conclusion. See, for example, Reuven Avi-Yonah and Mohanad Salaimi, 'Minimum Taxation in the United States in the Context of GloBE', 50(10) *Intertax* 673, 676. However, Avi-Yonah and Mohanad say that '[p]resumably, this outcome was not intended' at 677.

[45] GloBE Model Rules, above n 2, Art. 10.1.

[46] The other reason would be that the Inclusive Framework insisted that the GloBE Rules would only recognize 'CFC Tax Regimes' which appropriately credited taxes with higher priority than CFC Taxes in the GloBE priority ordering rules. The clearest example would be if the Inclusive Framework agreed that the QDMTT would apply 'ahead of' CFC Rules but the US did not grant a credit for amounts of QDMTT under its foreign tax credit regulations. I raised this possibility in a prior article. See Wardell-Burrus, 'Should a Foreign Tax Credit be given for QDMTT?', above n 33, 1655.

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3. Allocating GILTI as a CFC Tax Regime

If the GILTI regime is determined to be a 'CFC Tax Regime' under the GloBE Rules, there will need to be a mechanism to allocate the CFC Tax between the various CFC jurisdictions. This is not a simple task. The GILTI regime does not, in its current form, calculate liabilities on a jurisdiction-by-jurisdiction basis. Accordingly, the Inclusive Framework will need to design an allocation formula for 'pushing down' the CFC Tax between the undertaxed entities for the purposes of the GloBE Rules analysis. The essence of the difficulty is that it involves taking an impure worldwide taxation regime and attempting to allocate it into a predominantly territorial regime (the GloBE Rules). The allocation mechanism will be important for determining whether the treatment of the GILTI regime will impose additional liabilities on US MNEs. There will be an inherent trade-off for the Inclusive Framework between getting the 'correct' answer and applying a simple methodology.

3.1. A Simplified Example

As the process is complicated, this section proceeds by providing a simplified example (though it may not strike readers as simple) and then consider the current and potential treatment of the GloBE Rules to that example if the GILTI regime is treated as a CFC Tax regime.[47]

Consider the following example:[48]

[47] This section considers the GILTI regime specifically. For an excellent overview of the interaction issues between CFC Taxes and the GloBE Rules in general, see Brian Arnold, 'An Investigation into the Interaction of CFC Rules and the OECD Pillar Two Global Minimum Tax', 76(6) *Bulletin for International Tax*, 270.

[48] This is a modified version of Example 7 used by the New York State Bar Association Report on Pillar Two. New York State Bar Association Taxation Committee, Report No. 1465-Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two), 21 July 2022, (available at https://nysba.org/app/uploads/2022/07/1465-on-the-OECD-Global-Anti-Base-Erosion-Model-Rules-Pillar-Two.pdf, accessed 5 December 2022).

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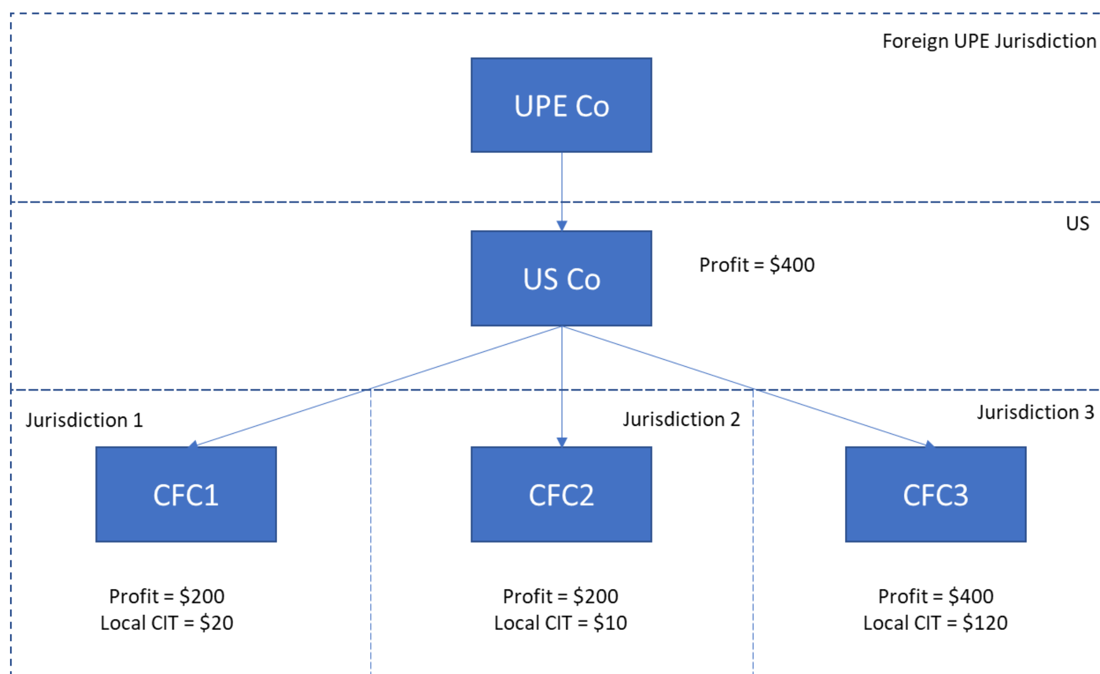

An MNE is headquartered in a foreign jurisdiction and is subject to a qualified IIR. The Ultimate Parent Entity (UPE Co) has a US subsidiary (US Co) which itself has three foreign subsidiaries – CFC1 (located in Jurisdiction 1), CFC2 (Jurisdiction 2) and CFC3 (Jurisdiction 3). US Co has $400 of profit (all figures in this simplified example assume that there is no difference between the GloBE and US tax base). CFC1 has derived $200 of profit within Jurisdiction 1 and is subject to $20 of regular Corporate Income Tax in Jurisdiction 1. CFC2 has derived $200 of profit within Jurisdiction 2 and is subject to $10 of regular Corporate Income Tax in Jurisdiction 2. CFC3 has $400 of profit in Jurisdiction 3 and is subject to $120 of regular Corporate Income Tax. For simplicity, this example assumes there is no SBIE or 'Net Deemed Tangible Income Return' in the CFCs.[49]

The US GILTI Regime applies as follows:

	US 'Source'	GILTI	GILTI FTC Limitation Calculation.
Profit / GILTI Income	400	650	650
Section 78 Gross-up[50]	0	150	150

[49] It also assumes (for now) that the MNE has not made the High Tax Exclusion election. This complication is addressed in section 3.5 below.

[50] The GILTI rules operate by including as GILTI income the *after-tax* amount as GILTI Income. It then provides a 'section 78 gross-up' which adds back the foreign tax credit amounts (not subject to the 20% haircut). See IRC § 78.

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Total Gross Income	400	800	800
US Allocated Expenses		N/A	(100)
Section 250 Deduction		(400)	(400)
Taxable Income	800[51]		300
Tax @ 21%	168		63
Foreign Tax Credits			[150 foreign taxes]
Gross FTC (80% of FTC)	120 (0.8*150)		
Allowed FTC	63 (reduced by FTC limitation)		
US Tax	105		
Total World Tax	255		

In this case, the US GILTI regime has increased the total amount of tax on US Co. If there had been no CFCs at all,[52] the US entity would have paid 21% tax on its 400 of profit ($84). Compared to this baseline, the CFC regime has imposed an additional $21 in taxes on the $800 of CFC income. It has reached this outcome by including the income of the CFCs but (a) giving a 50% deduction on that income, (b) giving a foreign tax credit equal to 80% of the foreign taxes paid and (c) restricting the use of foreign tax credits based on expense allocation rules.[53] The foreign tax credit limitation is calculated (see final column) by applying a similar calculation but also taking into account expenses which were incurred in the US but are allocated to the foreign income for the purposes of the FTC limitation calculation. In this case, the FTC limitation is $63.[54] The result of this calculation is a total US tax liability of $105.[55] The question for the GloBE Rules is to determine how much of the $105 US tax liability is a relevant 'CFC Tax' and then how to allocate the CFC Tax between CFC1, CFC2 and CFC3.

[51] $800 = ($400 + $800) - $400. For clarity, this is 400 of US source profit plus 800 of (post-section 78 gross-up) GILTI Income, reduced by the $400 section 250 deduction.

[52] Assuming that this did not impact the expenses in the US.

[53] In this example, I have simply posited that 100 of expenses have been allocated to the CFCs. This would be determined under the relevant regulations for allocating the relevant expenses. These are addressed further below.

[54] The 'cap' on foreign tax credits is 63. This is reached by taking into account total GILTI income (post-section 78 gross-up) of $800, subtracting the $400 section 250 deduction and then further subtracting the allocated expenses of $100. The resulting income figure ($300) is multiplied by the US corporate tax rate of 21% to reach $63.

[55] This figure is reached as follows. There is total income of $1200 (including both US source and GILTI income), reduced by a section 250 deduction of $400 and multiplied by the 21% rate ($168 = ($1200 - $400) * 21%). This figure is reduced by total allowable tax credits of $63. The result is a total US tax liability of $105 ($168-$63).

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3.2. The Methodology in the Commentary

The primary allocations under the GloBE Rules are simple. CFC1 has paid $20 of CIT on $200 of profit (10%), CFC2 has paid $10 of CIT on $200 of profit (5%) and CFC3 has paid $120 CIT on $400 of profit (30%). These Corporate Income Tax amounts are Covered Taxes and allocated to jurisdictions 1, 2 and 3 respectively. The question is whether there is any CFC Tax allocation to those jurisdictions from the US.

Under Art. 4.3.2(c), where there is a:

> *Constituent Entity whose Constituent Entity-owners are subject to a Controlled Foreign Company Tax Regime, the amount of any Covered Taxes included in the financial accounts of its direct or indirect Constituent Entity-owners under a Controlled Foreign Company Tax Regime on their share of the Controlled Foreign Company's income are allocated to the Constituent Entity;*

As noted above, the GILTI regime is (barring agreement to the contrary) a CFC Tax Regime. Accordingly, the question is whether there are Covered Taxes in the accounts of the parent entity (US Co) on the income of CFC1, CFC2 or CFC3. The GloBE Rules do not themselves say how to determine whether there have been Covered Taxes on the CFC's income. However, the Commentary does provide a methodology.

The Commentary on Art. 4.3.2(c) states that the process which applies to allocating taxes between a Permanent Establishment and the 'Main Entity' also applies to allocating CFC Taxes to foreign subsidiaries.[56] That allocation mechanism sets out a three-step process.[57]

<u>Step 1</u>

First, it is necessary to determine how much of the CFC's income is included in the Parent's taxable income.[58] In this case, the GILTI regime has directly included $180 of CFC1's income and applied a section 78 gross-up to reach the original $200 of profit made in CFC1. While not directly contained in the Commentary, it would seem strange not to allow for the full $200 to be taken into account under the GloBE Rules. However, this is the first of several interpretive 'leaps' that are required to apply the GloBE

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[56] See OECD (2022), 'Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)', OECD, Paris ('Commentary to the GloBE Model Rules'), paragraph [58].
[57] That section sets out the process with respect to the 'Permanent Establishment' and 'Main Entity'. Here, I have converted it to the 'CFC' and 'Parent'.
[58] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [47].

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Rules to the GILTI regime. Note that at this stage, we do not inquire as to whether the tax is itself a 'Covered Tax'.[59] The respective figure for CFC2 is $200 ($190 + $10) and for CFC3 is $400 ($280 + $120).

Step 2

The second step is to determine how much of the Parent's tax liability has arisen from the CFC's income.[60] To do so, the Parent's 'pre-foreign tax credit tax liability' on all income needs to be determined and allocated between the CFC and the Parent. In our case, the total 'pre-foreign tax credit tax liability' of the parent is $168.[61] This is reached by including the income of US Co, CFC1, CFC2 and CFC3 (total of $1200), then subtracting the section 250 deduction ($1200 - $400 = $800) and multiplying the remainder by 21% ($800*21% = $168).

This $168 then needs to be allocated between the Parent, CFC1, CFC2 and CFC3. In this case, there are no losses which are offsetting the respective profits.[62] However, if we simply allocated according to the included income of each entity, the allocation would be 33% to US Co, 16.6% to each of CFC1 and CFC2, and 33% to CFC3.[63] The problem with this approach is that it would ignore the impact of the section 250 deduction. The US GILTI regime grants a deduction equal to 50% of the effective GILTI inclusion.[64] If the allocation mechanism does not take this into account, the GloBE Rules would be allocating a portion of the section 250 deduction to the US sourced profit. Considering the design of the GILTI regime, it would be clearly misleading if the section 250 deduction were not fully allocated to the GILTI income. The rules should produce an outcome which is equivalent to including 50% of the CFC's income. It seems clear that the only sensible approach would require taking the section 250 deduction into account so that the allocation of the $168 is based upon the ratio of $400 to the Parent Co, $100 to each CFC1 and CFC2 (based on a $200 inclusion reduced by the $100 section 250 deduction) and $200 to CFC3. This produces a Step 2 allocation of $21 for each CFC1 and CFC2, and an allocation of $42 for CFC3.[65]

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[59] Technically, the rules operate by allocating Covered Taxes and then reducing Covered Taxes by amounts of Covered Taxes on non-GloBE Income to reach Adjusted GloBE Income – see GloBE Model Rules, above n 2, Art. 4.1.3(a).

[60] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [48].

[61] (($400 + $800) - $400) * 21%.

[62] If there are losses in the US Parent which reduce the total GILTI liability, the amount of total CFC Tax to be pushed down into the CFCs would be reduced.

[63] This is their respective profit divided by their total profit of $1200.

[64] That is, the GILTI Income plus the section 78 gross-up. This is until 2026 when the section 250 deduction is reduced.

[65] This is, $126 * ($100/$600).

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It is worth pausing to note the arguable arbitrariness of taking the section 250 deduction into account without taking into account any other deductions which are related to the derivation of this income. The section 250 deduction is given to the taxpayer as a function of the amount of income which makes the connection between the two more obvious. However, logically, there are a variety of other expenses which are taken referable to this income. The US rules address these through the foreign tax credit limitation (which is addressed in greater detail below) but that they are still conceptually relevant to this step. It is also worth noting that this distinction needs to be inferred as being on 'a reasonable basis' and is not set out in the GloBE Commentary.

Step 3

The third step is to determine the tax credit which is allowed with respect to any taxes paid by the CFC. This is a difficult task under the GILTI regime because it allows for 'cross-crediting'. The Commentary states:

> *In these cases, the amount of the foreign tax credit attributable to the [CFC Income] has to be determined based on the rules of the jurisdiction and using reasonable assumptions where necessary.*[66]
>
> *…*
>
> *The amount of Covered Taxes paid on [CFC] income inclusions is the excess of the tax liability arising from the [CFC] income inclusions over any credit allowed for the [CFC's] Taxes on its income.*[67]

The Commentary goes on to say that:

> *The foregoing three-step process determines the amount of Tax to exclude from the [Parent's] Covered Taxes. Once that amount is determined, however, those Taxes have to be allocated to the jurisdiction of the relevant [CFCs] if the [Parent] was subject to tax on the income of more than one [CFC].*

In our example, CFC1 has paid $20 in Corporate Income Tax to Jurisdiction 1, CFC2 has paid $10 in Corporate Income Tax to Jurisdiction 2 and CFC3 has paid $120 in CIT to Jurisdiction 3. However, the GILTI regime does not allow all of these as foreign tax credits. First, there is a 20% 'haircut' which reduces the

[66] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [49].
[67] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [50].

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total FTCs from $150 to $120.[68] Second, there is the foreign tax credit limitation. As noted above, the foreign tax credit limitation has reduced the available tax credits from $120 to $63.

The Parent's pre-foreign tax credit tax liability on the CFC income inclusion was $84 (as per Step 2) and the total allowed foreign tax credits is $63. Accordingly, there is a $21 remainder which is excluded from US Co's GloBE Covered Taxes. This suggests that US Co would have Covered Taxes of $84 ($105 - $21). This may seem intuitive as the US Co has derived $400 in profit which would have been subject to a 21% tax rate to equal $84.[69]

As noted in the Commentary, the steps so far have only determined how much tax is to be allocated to the CFCs in total (or allocated away from the US). The next step is to allocate the $21 of CFC Tax between CFC1, CFC2 and CFC3. The GILTI regime allows for the cross-crediting of taxes which makes this allocation complicated. The GloBE Commentary states:

> *In other cases, the creditable Taxes may be subject to limitations or cross-crediting may be allowed. In the case of credit limitations, the MNE Group will need to determine the allowed credit for foreign taxes on each [CFC] income inclusion* <u>*based on the rules of the jurisdiction*</u>*, and where necessary make reasonable assumptions.*[70]
>
> (emphasis added)

Accordingly, the Commentary suggests that we are to look to US tax principles to make the allocation. This is arguably difficult because the US tax rules do not determine the FTC limitation on a CFC-by-CFC basis. The allocation method therefore must determine how many of the tax credits of each of CFC1, CFC2 and CFC3's taxes have been 'allowed'. In this example, the FTC limitation has reduced the total allowed FTC credits from $120 to $63. If it weren't for this step, we could simply say that CFC1 had $16 in credits (0.8*$20), CFC2 had $8 in credits (0.8*$10) and CFC3 had $96 (0.8*$120). However, the FTC limitation means that we must allocate the *disallowed* credits between CFC1, CFC2 and CFC3.

It is not obvious how to reasonably allocate the disallowance of tax credits. Neither the US tax rules nor the Commentary provide a direct answer to this question. The allocation method could opt for simplicity

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[68] See IRC § 960(d)(1).

[69] However, it is important not to forget that this $400 is reached by taking into account expenses in the US Parent which, under US tax principles, are allocated to the CFCs. In other words, despite the fact that the expenses are allocated to the CFCs for the purpose of determining the foreign tax credit limitation, they are still available to reduce the US taxable income.

[70] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [51].

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and use a general rule such as allocating the disallowed credits in proportion to the tax credits in the jurisdiction.[71] In this case, the allocations would be:

- $7.6 = $57 * ($16/$120) for CFC1;
- $3.8 = $57 * ($8/$120) for CFC2; and
- $45.6 = $57 * ($96/$120) for CFC3.

Once these allocations have occurred, the Commentary provides a mechanism for dealing with the allowed cross-crediting. The Commentary states:

> *Where cross-crediting is allowed, the Taxes paid in respect of an inclusion should be determined by subtracting the credit allowed for Taxes paid by the particular [CFC], and then further subtracting an appropriate amount of excess creditable Taxes paid by other [CFCs] from the pre-credit tax liability of the [CFC]. The appropriate amount of excess creditable taxes should be determined by allocating the total amount of excess creditable taxes among [CFC] inclusions based on the relative residual tax liability due to each [CFC] inclusion taking into account only creditable taxes paid by that [CFC] (i.e. the liability after the credit for taxes paid by the [CFC] but before excess credits are allocated).* [72]

It is not entirely clear what 'excess creditable taxes' means in this context. The best reading seems to be tax credits in excess of the 'pre-credit tax liability' of each CFC. However, this still requires determining the 'allowed tax credits' for each of the CFCs. This assumedly is not satisfied by simply taking into account the 20% haircut and would require an allocation of the disallowed tax credits as outlined above. Accordingly, the mechanism for allocating disallowed credits between the CFCs does not appear to be resolved by this method. However, using the allocation methodology for disallowed tax credits provided above, this step would be applied as follows:

- $8.4 of allowed tax credits for CFC1 ($16 - $7.6);
- $4.2 of allowed tax credits for CFC2 ($8 - $3.8); and

[71] It should be noted that allocating the *disallowance* of credits in proportion to the value of tax credits provided by the relevant CFC produces the same outcome as allocating the *allowed* tax credits in proportion to the value of the tax credits. However, these steps have been kept separate to avoid confusion when thinking about the correct result when the disallowance of credits is not allocated proportionately.

[72] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [52].

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- $50.4 of allowed tax credits for CFC3 ($96 - $45.6).[73]

	Post-haircut FTCs	Allowed Tax Credits[74]	Pre-credit tax liability	Excess creditable taxes	Reallocation	Post re-allocation tax credits	CFC Tax Allocation
CFC1	$16	$8.4	$21	-	$3.65[75]	$12.05	$8.95[76]
CFC2	$8	$4.2	$21	-	$4.75[77]	$8.95	$12.05[78]
CFC3	$96	$50.4	$42	$8.4[79]	-	$42	$0
Total	$120	$63	$84	$8.4	$8.4	$63	$21

Only CFC3 has allowed tax credits which exceed its 'pre-credit tax liability' (this should be unsurprising as only CFC3 has an ETR above 13.125%). The excess creditable taxes of $8.4 then need to be allocated between CFC1 and CFC2. This is done based on the 'relative residual tax liability due to each [CFC] inclusion' taking into account only creditable taxes paid by that CFC. CFC1 has a 'residual tax liability' of $12.6 ($21 - $8.4) and CFC2 has a residual tax liability of $16.8 ($21 - $4.2). Accordingly, the $8.4 in excess creditable taxes is allocated between CFC1 and CFC2 in proportion to these ratios. The result is a reallocation of $3.65 to CFC1 and $4.75 to CFC2. This produces a final allocation of tax credits of $12.05 (CFC1), $8.95 (CFC2) and $42 (CFC3).

The above step has only determined the total allocation of the $63 in allowed foreign tax credits under the GloBE Rules (that is, the Step 3 allocation). In order to reach the CFC Tax allocation for each CFC, we need to subtract the Step 3 allocation from the CFC's Step 2 amount (that is, the pre-foreign tax credit liability). As shown in the final column, this is $8.95 for CFC1, $12.05 for CFC2 and $0 for CFC3.

[73] This allocation has been done using the 'post-haircut' amount of allowed foreign tax credits. However, as all the tax credits are subject to the 20% haircut in IRC § 960(d)(1) , the proportion (and therefore the allocation) would have remained the same if the pre-haircut foreign tax credit figures were used.
[74] The Commentary refers to 'the credit allowed for Taxes paid by the particular [CFC]'. This would require taking into account the foreign tax credit limitation and therefore allocating the disallowed tax credits between the various CFCs. These figures have assumed a disallowance of $7.6 to CFC1, $3.8 to CFC2 and $50.4 for CFC3 (as outlined above). The result is a total disallowance of $57 which is the total post-haircut tax credit amount of $120 ($150*0.8) less the FTC limitation amount of $63.
[75] $3.65 = $8.4 * ($12.6 / ($12.6 + $16.4)). This figure is rounded to two decimal places.
[76] $8.95 = $21 - $12.05.
[77] $4.75 = $8.4 * ($16.4 / ($12.6 + $16.4)). This figure is rounded to two decimal places.
[78] $8.95 = $21 - $8.95.
[79] $8.4 = $50.4 - $42.

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The final step is to consider what impact this has on the GloBE calculation for each of the CFCs. This is set out in the below table.

	CFC1	**CFC2**	**CFC3**	**US**
GloBE Profit	$200	$200	$400	$400
Corporate Income Tax	$20	$10	$120	$84
CFC Allocation	$8.95	$12.05	$0	N/A
Adjusted Covered Taxes	$28.95	$22.05	$120	$84
ETR	14.475%	11.025%	30%	21%
Top-up Tax Percentage	0.525%	3.975%	N/A	N/A
IIR	$1.05	$7.95	N/A	N/A
Total Tax	$30	$30	$120	$84
Worldwide Total	$264			

It is revealing to compare this example to a case where there was no GILTI regime at all and that the US tax system simply imposed a 21% tax rate on the US sourced profit.

	CFC1	**CFC2**	**CFC3**	**US**
Profit	$200	$200	$400	$400
Corporate Income Tax	$20	$10	$120	$84
ETR	10%	5%	30%	21%
Top-up Tax Percentage	5%	10%	N/A	N/A
IIR	$10	$20	N/A	N/A
Total Tax	$30	$30	$120	$84
Worldwide Total Tax	$264			

When one steps back from the detailed methodology, a few points become clear. First, the total allocation of CFC Tax is equal to $21, which is the amount by which the total US tax liability exceeded the amount

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we expected the MNE to pay with respect to its US profits.[80] Second, there was no allocation to CFC3 (which we might initially expect as CFC3 has had its income subject to tax at a 30% rate). Third, the allocation mechanism has allocated more to CFC2 than CFC1 but not twice as much (as one might initially expect from the fact that CFC2 was subject to only half the initial tax rate as CFC1). Fourth, there is no difference in the total tax paid between the case where the GILTI regime is applied as a CFC Tax and pushed down and the case where there is no GILTI regime at all.[81] Fifth, the GILTI regime has just reduced the IIR tax. In the absence of the GILTI regime, there would be $30 in IIR and US tax of $84. By allowing this CFC pushdown allocation, there is $9 in IIR and $105 in total US Corporate Income Tax ($84 + $21) as opposed to $30 in IIR and $84 in US Corporate Income Tax. The GILTI regime has essentially jumped ahead of the IIR to claim the top-up tax.

This simplified example has not yet taken into account (at least) four important issues. First, the example assumed that there was profit in the US Parent. If there was a net operating loss (NOL), this loss would reduce the CFC taxes imposed by the parent. Second, the example assumed that there was no SBIE in any of the CFC jurisdictions. Third, the example assumed that the MNE has not made a GILTI 'High Tax Exclusion election' which would exclude CFC3 from the GILTI calculation. Fourth, the above example has considered an expense allocation of $100 to the GILTI basket without considering the possibility that the expense allocation may arise predominantly with respect to certain CFCs and not others. The allocation of expenses determines the disallowance of tax credits. The above methodology simply assumed that the disallowance would be allocated proportionately. However, if the expenses are being allocated only with respect to a single jurisdiction, a proportionate allocation may be considered inappropriate. Each of these issues is addressed below.

3.3. Losses in the Parent Jurisdiction

There is a complication which arises if there is a domestic loss in the US Parent. Domestic losses reduce the amount of tax which will be imposed under the GILTI regime. As shown above, the GILTI regime does not calculate a separate tax which is imposed only with respect to the active income of foreign subsidiaries. Instead, it includes the relevant income in the income of the parent. However, the US shareholder can use other deductions (for example, from its US operations) to reduce the total US tax

[80] $21 = $105 – ($400*21%). However, recall that this $400 in US profit takes into account US expenses which are allocated to the CFCs under expense allocation rules for the purposes of determining the foreign tax credit limitation.
[81] However, it is important to recall that this example had no SBIE. This outcome is unlikely if there is SBIE.

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liability. In effect, US losses (deductions which exceed income from the US operations) reduce the GILTI liability which would otherwise arise.

If these losses did not reduce the US GILTI liability, they would have been available to carry forward to a following year to reduce both the US tax liability and any potential GloBE liability with respect to the US as a jurisdiction.[82] In such a case, the GILTI tax would still be payable by the US Parent even if there were domestic losses. This would produce a sensible result from the perspective of the GloBE Rules – the US losses would count towards the US and the CFC Tax would count towards the foreign subsidiary jurisdictions. However, that is not how the GILTI regime operates. If the rules aim to maintain the purity of jurisdictional blending under the actual GILTI regime, there would need to be a mechanism for effectively reallocating the losses to the parent jurisdiction when they had been used to reduce CFC Taxes. The most likely candidate for building such a mechanism is the deferred tax accounting infrastructure which is generally used to address timing differences. This is because this issue does not only arise with respect to domestic losses in the current year but also to carry-forward net operating losses (NOLs). The proper design of such a mechanism is beyond the scope of this paper.

3.4. SBIE

The SBIE complicates matters because it reduces the top-up tax that would otherwise have arisen under the GloBE Rules. The allocation mechanism is only relevant for determining what, if any, top-up taxes are owed with respect to the GloBE Rules. There are effectively three ways in which the above allocation mechanism can 'waste'[83] CFC Taxes (by which I simply mean the allocated CFC taxes do not reduce the amount of top-up tax which would otherwise fall due under the GloBE Rules). First, it could allocate CFC Taxes to a jurisdiction with a QDMTT if the QDMTT applies 'ahead of' the CFC allocation (this is addressed in Part 4). Second, the allocation mechanism could allocate 'GILTI Tax' to a jurisdiction which already has an ETR of above 15%. This could arise for a variety of reasons. There could be relevant differences in the tax bases. There could also be other Constituent Entities in the jurisdiction which are not owned by the relevant US shareholder (and therefore are not blended under the GILTI Rules) but nevertheless raise the jurisdictional ETR above 15%. Third, the GILTI Tax could be allocated to a jurisdiction that has significant SBIE.

[82] See GloBE Model Rules, above n 2, Art. 4.4 with respect to timing differences and Art. 4.5. with respect to the GloBE Loss Election.

[83] In this context, I am using a simplified concept of 'waste' under which the allocation of the CFC Tax does not reduce the GloBE Tax liability at all (that is, there is no benefit from the allocation).

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The impact of SBIE is complicated but most easily demonstrated in an extreme example.[84] Consider a jurisdiction which has more SBIE than it has in GloBE Income. This jurisdiction has no Excess Profits under the GloBE Rules and therefore will have no top-up tax liability *regardless of the ETR* for the jurisdiction. The MNE would not want additional GILTI Tax to be allocated to such a jurisdiction because that tax allocation would not reduce the top-up tax liability for the jurisdiction. The MNE would be better off having the tax allocated to another low tax jurisdiction which did have Excess Profits.[85]

The interaction between the GILTI Rules and SBIE is complicated by the fact that the GILTI regime already has its own similar concept in Net Deemed Tangible Income Return (NDTIR). As noted above, NDTIR is a carve-out for a formulaic return on the tangible assets in the jurisdiction. While both are effectively 'carve-outs' from the respective top-up tax regimes, they apply in a different order. Under the GILTI Regime, the active profit of the CFC is effectively reduced by the amount of NDTIR before being included in the US shareholder's tax base. A corresponding adjustment to the amount of Foreign Tax Credits is made. For example, if there is a CFC which has paid $20 of Tax on $100 of full profit but has NDTIR of $25, the US Shareholder would include $75 of income and $15 of foreign tax credits.[86] The $20 of taxes are effectively allocated pro rata between the NDTIR amount (25%) and the GILTI Income amount (75%). Tax credits are only allowed for the latter (and then subject to the haircut and potential foreign tax credit limitations).

The GloBE Rules effectively operate in the reverse order. The ETR for the jurisdiction is determined without taking into account the SBIE. However, the top-up tax percentage is only applied to the Excess Profit (total profit less SBIE). This means that all of the SBIE in the jurisdiction is effectively lumped together and taken into account after the ETR has been determined. The GILTI regime and the GloBE Rules are both effectively imposing tax on 'residual profit' (although this is defined differently under each regime).[87] However, they are achieving this outcome in importantly different ways. If the GILTI tax is allocated under the GloBE regime, the amount of the tax is effectively 'diluted' by which I mean spread across both the 'normal profit' and the 'residual profit'. This can be demonstrated by a simple example.

Consider a case in which both the GILTI regime and the GloBE regime would impose $15 of tax with respect to a single subsidiary in jurisdiction X with no corporate income tax. This jurisdiction has $150 of total

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[84] I have written separately about SBIE as a new valuable tax attribute – see Wardell-Burrus, 'Tax Planning Under the GloBE Rules', above n 19, 645.

[85] I have written separately on MNE tax planning strategies to achieve this outcome. See Wardell-Burrus, 'Tax Planning Under the GloBE Rules', above n 19, section 2(d).

[86] This is prior to the 20% 'haircut' which reduces the available foreign tax credits.

[87] For an excellent analysis on different concepts of 'excess returns' see Lilian V. Faulhaber, 'Lost in Translation: Excess Returns and the Search for Substantial Activities', 25 *Florida Tax Review* 545 (2022).

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profit and $50 of NDTIR and SBIE (that is, the substance-based carve-out is the same in both jurisdictions). In effect, this would mean that both systems are recognizing $100 of 'residual profit' which is subject to the top-up tax regime. Let us assume that the GILTI regime applies first and there is an allocation of $15 of GILTI to Jurisdiction X for the purposes of the GloBE Rules. That is, the US is imposing $15 of tax on the residual profit in the jurisdiction. However, if the GILTI regime is treated as a CFC Tax under the GloBE Rules, there would be additional top-up tax. The GloBE Rules would calculate the ETR of the jurisdiction as 10% ($15 / $150 in total tax). It would then apply the 5% top-up tax percentage to the Excess Profits of the jurisdiction ($100) to impose GloBE top-up tax of an additional $5. The result would be total tax of $20 ($15 under GILTI and $5 under GloBE).

What has happened? We assumed that both regimes treat the jurisdiction as having residual profits of $100 because both regimes have (a) the same amount of total profit ($150) and (b) the same substance-based carve-out amount ($50). Furthermore, both regimes *applying on their own* would impose $15 of tax (a 15% tax on the residual profit). However, the GloBE calculation does not recognize that the GILTI tax is being paid with respect to the Excess Profits. Instead, it treats the amount as being applicable to the total profits. As a result, the GloBE mechanism effectively *dilutes* the GILTI tax. That is, it is treated as having been imposed with respect to both the 'normal profits' (SBIE) and the Excess Profits of Jurisdiction X.

This is how the GloBE Rules treat all Covered Taxes.[88] They are effectively allocated pro-rata between the amounts of SBIE and Excess Profit *regardless of how the Covered Tax is calculated*. The only tax which the GloBE rules treats as having been paid only on Excess Profits is the QDMTT.[89] In this context, it is important to recall that this is also how the GILTI regime treats any local taxes in Jurisdiction X.[90] Nevertheless, it is important to note that the impact of layering the two top-up taxes which are imposed on residual profit is that there is an increase in overall tax compared to what would have been applied under either regime. In other words, the taxpayer does not simply pay the greater of the GloBE or GILTI amounts, the result is that the MNE will pay more than it would under either regime separately.

[88] It would have been impossibly complicated to attempt to 'trace' the different amounts of covered taxes to different parts of the tax base. That is, to allocate Covered Taxes between amounts of SBIE and Excess Profit on a factual basis rather than using a pro rata allocation mechanism.
[89] Accordingly, the QDMTT receives advantageous treatment compared to other taxes. See Devereux, Vella and Wardell-Burrus, 'Pillar 2's Impact on Tax Competition', above n 14, section 3.
[90] That is, the GILTI regime does not accept any taxes in the CFC jurisdiction as having only been applied to the 'residual profits' in the jurisdiction. It also spreads any other taxes between the NDTIR amount and GloBE Income amounts.

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In addition to this dilution effect, the allocation mechanism could result in taxes being allocated to jurisdictions with different amounts of SBIE. This can result in 'wasted' GILTI allocations. The main example above assumed that there is no SBIE and no NDTIR. For simplicity, let us modify the example to assume that Jurisdiction 1 (with CFC1) has SBIE of $200.[91] In this case, there is no IIR liability with respect to CFC1 because there is no Excess Profit (Jurisdiction has total profit of $200 and SBIE of $200 – therefore it has no 'Excess Profit'). There would be no IIR liability regardless of the ETR in Jurisdiction 1. As a result, the allocation of $8.95 of CFC Taxes to CFC1 will not reduce the MNE's IIR liability at all. The MNE would have been much better off if it could have allocated that additional $8.95 to CFC2. This would have raised the ETR of CFC2 to 15% and reduced the total IIR to nil.[92]

This simple example shows that the allocation of CFC Taxes is not a 'zero sum game'. MNEs are incentivised to allocate their CFC Taxes to low tax and low SBIE jurisdictions to maximise their value. This demonstrates one of the ways in which the allocation mechanism is key. The above allocation mechanism does not take the underlying SBIE amounts into account and therefore allows for the 'waste' of CFC Taxes on this basis. Of course, this is not necessarily a bad thing. There do not appear to be sound policy reasons for allowing US MNEs to allocate their CFC Taxes in order to maximise their value under the GloBE Rules. Put differently, if CFC Taxes are paid by the MNE with respect to a high SBIE jurisdiction they arguably ought to be 'wasted' from the perspective of the GloBE Rules. In this context, it is important to recall that the GILTI regime does reduce the amount of CFC Tax based upon NDTIR.

3.5. High Tax Exclusion

The third issue which has been overlooked is the role of the GILTI 'High Tax Exclusion'. Under US Treasury Regulations, a shareholder can make an election which will effectively exclude from their GILTI Income, the profits of CFCs that have been subject to tax at greater than 90% of the US tax rate (that is, 18.9% as determined by US tax principles).[93] There are at least two flow-on effects from this election. The first is that the US Shareholder is not entitled to use foreign tax credits with respect to this income against other GILTI Income. Accordingly, the US Shareholder would lose the 'blending benefit' with respect to this high tax jurisdiction. This is a downside for the relevant taxpayer. The second effect is that the relevant income

[91] We will assume that there is no change in the GILTI liability. This could be because all of the SBIE related to payroll expenditure and not due to tangible assets located within the jurisdiction. Accordingly, we assume that there is NDTIR of nil.

[92] This would involve allocating $20 of CFC Tax to CFC2. Accordingly, its total Covered Taxes would be $30 ($10 in corporate income tax and $20 of allocated CFC Tax) on $200 of GloBE Income. This is an ETR of 15%.

[93] The details of the GILTI 'High Tax Exclusion' are found in T.D. 9902; 85 F.R. 44620-44649; 2020-33 IRB 349. It should be noted that the validity of these regulations has been questions. See, for example, Stephen Shay, 'A GILTI High-Tax Exclusion Election Would Erode the U.S. Tax Base', *Tax Notes Federal,* 18 November 2019, 1129.

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is excluded from the GILTI 'basket' for the purposes of calculating the allocation of expenses. This is an important benefit because removing these expenses can prevent the foreign tax credit limitation from reducing the available credits from other jurisdictions. Accordingly, the High Tax Exclusion will often be an attractive option for US Shareholders that have excess foreign tax credits.

As the High-Tax Exclusion is an election, under current law we should generally expect that US taxpayers are likely to make that election if that election reduces their overall US tax. From a GloBE perspective, there is a question as to whether the allocation of CFC Tax to underlying entities for GloBE purposes can change the incentives for the High-Tax Election. At first it may seem that, at best, a dollar of additional tax under the GILTI regime can reduce the GloBE top-up tax by a dollar. In other words, the best that the MNE could do was 'break even'. Furthermore, as noted above, the presence of SBIE will generally 'dilute' the allocated CFC Tax such that an additional dollar of CFC Tax will not offset a dollar of GloBE Tax. Accordingly, one might expect that the incentives with respect to making the High Tax Exclusion remain unchanged – the US taxpayer should still seek to minimize its US tax burden as before.

Unfortunately, the answer to this question may not be so simple. The election must cover all the CFCs of the MNE. This requires the MNE making a calculated trade-off between the benefits and detriments for different CFCs and jurisdictions when making the election. In other words, this may be a benefit with respect to some jurisdictions and CFCs and a detriment with respect to others. The MNE balances these benefits and detriments to make the election if there is an overall benefit. If the allocation mechanism for CFC Taxes under the GloBE Rules is impacted by whether or not the election is made, the GloBE rules could impact whether or not a US MNE should make the election.[94]

This can be shown by considering the equilibrium case where the benefits of making the High-Tax Exclusion perfectly offset the detriments for US tax purposes only.[95] In such a case, the total US tax liability would remain the same whether (a) the high tax subsidiaries were included in the GILTI calculation or (b) they were excluded from the calculation. Unless the GloBE CFC Tax allocation mechanism is designed such that the exact same allocation occurs to all undertaxed jurisdictions regardless of whether the election is made, then the GloBE rules can provide an additional benefit to making (or not making) the election. This could happen simply because the methodology changed the allocation to a jurisdiction with a higher or

[94] This is particularly likely if the allocation of disallowed tax credits takes into account US expense allocation (see further below).

[95] This would have to be in a non-trivial case. For instance, this would technically be true if the MNE had no income which would be subject to the High Tax Exclusion at all.

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lower amount of SBIE. At least in theory, we should expect that MNEs seeking to minimize their overall tax liabilities would make the election taking into account the GloBE benefits including those that flow from the allocation. If this is true when the interests are perfectly balanced, it can also be true when they are not. That is, the benefit arising from the GloBE allocation as a result of not making the election may outweigh the benefit of making the election for US tax purposes. Accordingly, the GloBE Rules could impact whether or not an MNE should make the GILTI High-Tax Exclusion election unless the allocation methodology is completely unaffected.

3.6. Expense Allocation

The Commentary states that the MNE 'will need to determine the allowed credit for foreign taxes on each [CFC] income inclusion based on the rules of the jurisdiction, and where necessary make reasonable assumptions.'[96] As noted above, the US foreign tax credit limitation is not determined on a CFC-by-CFC basis. There are two key restrictions. First, there is a 20% haircut for relevant foreign taxes on GILTI Income. Second, there is a foreign tax credit limit which arises from the allocation of US incurred expenses to the basket with all GILTI Income. The above allocation mechanism operated on the basis that the disallowance of tax credits would be allocated between CFCs 'pro rata' based upon the number of foreign tax credits for that CFC. The problem is that a pro rata allocation of disallowed tax credits is not required under the rules of the jurisdiction and is, therefore, arguably not based on 'reasonable assumptions'.

There is no issue with using a pro rata allocation if the foreign tax credit limitation does not apply. In such cases, there is simply a 'haircut' for all foreign tax credits of 20%. There is no need to allocate disallowed foreign tax credits. This will already be proportionate to the creditable foreign taxes. However, if expense allocation is what provides the limiting factor then any methodology which does not take into account the allocation of expenses to each CFC jurisdiction would arguably be neither (a) based upon the rules of the jurisdiction (properly understood), nor (b) based upon 'reasonable assumptions'. This is because a pro rata allocation based on foreign tax credits would fail to take into account what is driving the disallowance of the foreign tax credits under the US foreign tax credit limitation rules – that is, the allocation of expenses. The methodology above would allocate the disallowance of foreign tax credits *proportionately to Foreign Tax Credits* even if the disallowance was driven by the allocation of expenses to only one jurisdiction (or several jurisdictions).

[96] Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [51].

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Before considering an example, it is worth noting that the US has extensive and complicated regulations for addressing the allocation of expenses. These differ depending upon the type of expense (for example, there are separate regulations for the allocation of research and development expenses and interest expenses). The US rules for allocation are well beyond the scope of this paper. For present purposes, the important fact is that there is an allocation mechanism for expenses which *could* be applied on a CFC-by-CFC basis. This is not currently required under the GILTI Rules. It is only necessary to allocate to the relevant baskets (one of which will contain all the GILTI Income from non-US jurisdictions). However, the capacity to do so is made clear by the High Tax Exclusion election which could shift individual CFCs into the non-GILTI basket for the purposes of expense allocation.[97] In other words, the calculation could be done on a jurisdiction-by-jurisdiction or CFC-by-CFC basis. Of course, this would involve a large increase in the number of separate calculations required.

Example

The above example stated that $100 of expense was allocated to the GILTI basket. However, let us assume that all $100 of that expense was allocated in respect of CFC3. That is, all $100 of expense would be allocated to CFC3 based upon the US FTC regulations allocation of expense methodology (treating each jurisdiction as a separate 'basket').[98] The methodology described above assumed that the disallowed foreign tax credits were allocated proportionately to the underlying tax credits. However, this is not consistent with what created the disallowance under the GILTI regime (and US foreign tax credit regulations) in this example. The disallowance was really driven by the allocation of expenses to CFC3 and it is arguably appropriate to reflect this by attempting to allocate the disallowance of foreign tax credits to CFC3. In other words, all of the disallowance should be with respect to CFC3. It should not be allocated proportionately between CFC1, CFC2 and CFC3 based on foreign tax credits. Without stepping through the entire example again using this new methodology, the results are as follows:[99]

[97] That is, one could generate a CFC-by-CFC allocation of expenses by imagining that each separate CFC were in a different 'basket' and applying the rules on that basis.

[98] To the extent that this is unrealistic, one could assume that some small portion of the expenses are allocable to CFC1 and CFC2. This seems possible if the allocation is driven by gross income rather than profit. In other words, we shouldn't expect the profit levels of CFC1, CFC2 and CFC3 to be reflective of the expense allocation.

[99] In continuing with this example, I have assumed that the MNE has not made the high tax exclusion election. However, nothing fundamentally turns on this. The same principle would apply with an allocation between CFC1 and CFC2.

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	Post-haircut FTCs	Allowed Tax Credits	Pre-credit tax liability	Excess creditable taxes	Reallocation	Post re-allocation tax credits	CFC Tax Allocation
CFC1	$16	$16	$21	-	-	$16	$5
CFC2	$8	$8	$21	-	-	$8	$13
CFC3	$96	$39	$42	-	-	$39	$3
Total	$120	$63	$84	$0	$21	$63	$21

The key difference is that CFC1 and CFC2 retain their full post-20% haircut foreign tax credits of $16 and $8 respectively. The whole disallowance is allocated to CFC3 which reduces its allowed tax credits to $39. This flows into the GloBE calculation as follows:

	CFC1	**CFC2**	**CFC3**	**US**
GloBE Profit	$200	$200	$400	$400
Corporate Income Tax	$20	$10	$120	$84
CFC Allocation	$5	$13	$3	N/A
Adjusted Covered Taxes	$25	$23	$120	$84
ETR	12.5%	11.5%	30.75%	21%
Top-up Tax Percentage	2.5%	3.5%	N/A	N/A
IIR	$5	$7	N/A	N/A
Total Tax	$30	$30	$123	$84
Worldwide Total	$267[100]			

In this case, there is $12 in IIR as opposed to $9 under the methodology above. This is the result of the allocation of $3 of the CFC Tax to Jurisdiction 3. It also increases the total tax paid by the MNE by the same amount.[101] This example shows that the allocation methodology is not a 'zero-sum game'. This does not merely influence whether the relevant tax amounts are paid under the GILTI regime or the IIR, it can

[100] This is CFC CIT payments of $150 ($20, $10 and $120) plus total US Tax of $105 and IIR of $12.
[101] The additional $3 of IIR does not change the underlying CIT in any of the CFCs nor the amount that is due by US Co to the US.

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change the total amount of tax paid by the MNE.[102] This allocation issue can produce 'waste' of GILTI tax in addition to three mechanisms outlined above.

It is not clear whether one or both of these methods would be allowed or required by the GloBE Rules. As noted above, the GloBE Commentary simply says that the allocation is to occur based on the rules of the jurisdiction and making reasonable assumptions where necessary. On the one hand, there is no requirement to undertake a CFC-by-CFC calculation under the GILTI regime (though separating the calculations is possible as demonstrated by the High Tax Exclusion). On the other hand, the allocation of expenses is what is driving the foreign tax credit limitation in such cases. There is an important question as to whether the Inclusive Framework wants the CFC allocation rules to reflect this. Of course, there may also be an argument that a simplifying assumption would be considered 'reasonable' even if it may produce the 'correct' outcome.

4. Should the GloBE Rules be deferential to the CFC Tax Regime?

In considering the detail of allocation methodologies, it is important not to overlook a more important higher-order question. What deference ought to be paid by the GloBE Rules to the CFC Regime itself? The methodology outlined in the GloBE Commentary requires allocating the CFC Taxes in accordance with the CFC regime itself. It operates by including the total amount of CFC Income and then subtracts the total *allowed* foreign tax credits. This is important because it thereby accepts any limitations on foreign tax credits imposed by the CFC regime. There is an important question as to whether the Inclusive Framework will be willing to agree to a methodology that gives deference to the foreign tax credit limitations under the CFC Regime. In other words, what should the priority ordering rules be between taxes under the GloBE regime?

4.1. Bifurcating CFC Regimes into Primary and Secondary Taxing Rights

In addressing this question, it is helpful to understand what the disallowance of foreign tax credits means from the perspective of understanding the priority between the income of the CFC jurisdiction and the parent jurisdiction. First, consider the case where (unlike the GILTI regime) a full tax credit is allowed under a CFC regime. Under this regime, the parent jurisdiction is clearly exercising '*secondary taxing*

[102] This is in addition to the impact created by the 'dilution' of GILTI taxes (addressed in section 2.4 above). In this example, there is no SBIE or NDTIR to produce the dilution effect.

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rights'. The income is that of the CFC itself (as properly determined under transfer pricing principles). The parent jurisdiction is recognizing the allocation and is giving full credit for the taxes paid in that jurisdiction. Under this design, the parent entity is only 'topping up' the relevant taxes to the CFC rate (usually the same as the domestic rate for passive income). In other words, the parent jurisdiction is recognizing the primary taxing rights of the CFC jurisdiction and giving full credit for those taxes when asserting its secondary taxing rights.

To the extent that the CFC regime denies foreign tax credits on the underlying income, the Parent jurisdiction is arguably asserting *primary taxing rights*. Despite the fact that transfer pricing provisions are allocating the relevant profit to the CFC jurisdiction, the Parent jurisdiction is not recognizing all of the tax which been paid in the CFC jurisdiction on that income. By refusing to give tax credits for all the taxes paid in the CFC jurisdiction, the Parent jurisdiction is effectively claiming *primary taxing rights* with respect to that income. The result is generally that both the CFC jurisdiction and the parent jurisdiction are asserting primary taxing rights. Neither is giving a tax credit for the taxes of the other which have been paid on the same income. The result could be described as economic 'double taxation'.

As explained by Paul Oosterhuis and Moshe Spinowitz, the US CFC regimes (both GILTI and Subpart-F) use expense allocation to divide the income of foreign subsidiaries into a component over which the US exercises *primary taxing rights* and a component over which the US exercises *secondary taxing rights*.[103] Effectively, where the US has given a tax deduction for expenses which are allocated to a foreign subsidiary, the US will deny the related tax credits and thereby assert primary taxing rights over the foreign subsidiary's related income. While this arises as a result of expense allocation, it also arguably results from the 20% 'haircut' for relevant foreign tax credits. The haircut means that the US is refusing to grant full credit for taxes paid under by the subsidiary.[104] Accordingly, both as a result of the 20% haircut and expense allocation, the US CFC regime bifurcates the foreign subsidiary's income into a component over which it asserts primary taxing rights and a component over which it asserts secondary taxing rights.

It is worth recognizing that thinking about the GILTI regime as asserting primary and secondary taxing rights is applying a territorial tax regime perspective to a (quasi-)worldwide taxation regime. It effectively assumes the proper allocation of profit to a jurisdiction and then considers which jurisdictions are

[103] See, for example, Paul Oosterhuis and Moshe Spinowitz, 'Why Treasury Got It Right: R&D Should Not Be Allocated to GILTI', *Tax Notes Federal,* 14 September 2020, 2041.
[104] It is worth noting that there are multiple reasons why the US can deny foreign tax credits for foreign taxes paid. For example, the prohibition on 'soak-up taxes', the denial of foreign tax credits which operate based on sourcing rules which are inconsistent with the US approach, and the 20% haircut all of have different justifications.

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imposing taxation with respect to that profit. The GloBE Rules fundamentally adopt a territorial approach which is based upon the transfer pricing regime correctly allocating profit between the constituent entities of the multinational enterprise.

Many practitioners accustomed to thinking from a worldwide tax regime perspective may not naturally think of expense allocation as bifurcating the CFC's tax base into a component over which the US is asserting primary taxing rights and a component over which it is asserting secondary taxing rights. From a worldwide tax regime perspective, the foreign tax credit limitation ensures that the US does not recognize more tax credits than the US would impose on the relevant income *if the allocated expenses had been deducted from the CFC's profit*. However, the crucial step to this thinking is that there are US expenses which are not taken into account in determining the profit of the CFC from a transfer pricing perspective but are nevertheless allocated to the CFCs under the US tax rules. The assertion of 'primary taxing rights' reflects the extent to which the transfer pricing regime does not accept the allocation of these expenses (as well as the 20% haircut). As the GloBE Rules adopt a territorial perspective, the remainder of this paper uses the terms 'primary taxing rights' and 'secondary taxing rights'. However, others may prefer to think of this bifurcation as the extent to which the US meaningfully asserts an allocation of expenses which are not recognized in reducing the profit of a jurisdiction under transfer pricing principles.

The fundamental question for the Inclusive Framework is whether the GloBE Rules should be willing to allocate additional taxes paid in the parent jurisdiction as a result of asserting both primary taxing rights and secondary taxing rights? Alternatively, should the GloBE Rules only be willing to allocate CFC Tax to a subsidiary jurisdiction where the CFC regime is asserting secondary taxing rights? Put in terms which would be more familiar to those with a worldwide taxation perspective, the question is how should the GloBE Rules take into account regimes which attempt to allocate expenses to foreign CFCs where those expenses are not reducing the profit of that jurisdiction under transfer pricing principles? Should the GloBE Rules defer to such CFC regimes by producing an outcome which is equivalent to allocating the expenses down to the CFC jurisdiction or not?

As a starting point, it is worth noting that the GloBE Rules and Commentary do not seem to give any significant guidance on the question. The definition of 'Controlled Foreign Company Tax Regime' is not limited to cases of asserting secondary taxing rights.[105] The related section in the Commentary does not

[105] "Controlled Foreign Company Tax Regime means a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign entity (the controlled foreign company or CFC) is subject to

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provide any further light on the question. Accordingly, one may be encouraged to simply accept that the CFC Tax includes the total amount and it is to be allocated down to the various subsidiaries. However, as noted above, the allocation mechanism is not clear. The Inclusive Framework could foreseeably agree that a ’reasonable’ allocation mechanism would allocate taxes arising from the denial of foreign tax credits to the US and not to the underlying jurisdictions. This question play an important role in determining the priority ordering rule of taxes created by the GloBE Rules.

4.2. Priority Ordering Rules

The GloBE Rules impose a minimum tax by creating a set of intertwining taxes which credit one another to create a ‘priority ordering rule’ between the taxes. There is a minimum amount of tax that needs to be paid overall, taking into account multiple potential taxes (Covered Taxes, QDMTT, IIR, UTPR). In order to prevent the minimum tax being imposed multiple times, there needs to be a priority rule under which lower priority taxes effectively ‘credit’ higher priority taxes. This means that the minimum tax is only imposed once. There are multiple ways in which the applicable taxes could be ordered. These ordering rules create important and different incentives for states in adopting or modifying tax regimes.

The ordering rules are created by the way in which each type of tax ‘takes into account’ (or credits) other taxes. For instance, the IIR takes into account the amount of Covered Taxes which have been paid in calculating the ETR and thus top-up tax which is due. This is the IIR effectively ‘crediting’ the Covered Taxes (even though it is not written as a ‘credit’). However, the IIR does not take into account any UTPR which is paid on the same profit. The UTPR does take into account any IIR which is paid with respect to an undertaxed jurisdiction.[106] Non-Covered Taxes are not taken into account by the IIR or UTPR. This design creates a simple priority rule:

1. Covered Taxes
2. IIR
3. UTPR
4. Non-Covered Taxes

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current taxation on its share of part or all of the income earned by the CFC, irrespective of whether that income is distributed currently to the shareholder.” See GloBE Model Rules, above n 2, Art. 10.1.

[106] The UTPR generally is ‘switched off’ to the extent that there is an applicable IIR (as opposed to simply subtracting the relevant IIR payments from the amount of UTPR which would otherwise fall due). This can be thought about as the equivalent of using the ‘exemption method’ rather than the ‘credit method’. However, for present purposes, this is equivalent to ‘crediting’ the IIR Tax for 100% of the UTPR which would otherwise fall due.

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The GloBE Rules do not prohibit the use of Non-Covered Taxes (for example, a tax imposed per tonne of iron ore), they simply do not take them into account in calculating the ETR for the jurisdiction. This means that such taxes are not 'credited' by the GloBE Rules. The GloBE Rules create this ordering rule through (a) the definition of Covered Tax and (b) the mechanism which switches off the UTPR to the extent that the IIR applies.[107] In particular, the definition of 'Covered Tax' determines which non-GloBE Taxes 'go first' (Covered Taxes) and which are only imposed after the IIR and UTPR (Non-Covered Taxes).

There is an important outstanding question as to where CFC Taxes should fall in the ordering rules created by the GloBE Rules. There are two important aspects to this question. First, whether CFC Taxes apply 'ahead of' or 'behind' the QDMTT. While it is clear that CFC Taxes would generally apply 'ahead' of the IIR and UTPR,[108] there is a currently unresolved question as to whether the QDMTT could be applied without taking CFC Taxes into account. I have argued elsewhere that jurisdictions ought to be able to adopt a QDMTT which does not give priority to CFC Taxes (that is, it does not take the CFC Taxes into account in calculating the QDMTT liability).[109] This is a very important debate and I will not repeat the full analysis here. Second, whether there is any difference in treatment between CFC Taxes imposing 'primary taxing rights' (PTR) as opposed to 'secondary taxing rights' (STR). The different answers to these questions create four possible ordering rules. For simplicity, I have left out 'source based' Covered Taxes which apply ahead of the Corporate Income Tax of the Constituent Entity (for example, allowed withholding taxes on income received by the Constituent Entity).

[107] GloBE Model Rules, above n 2, Art. 2.5.
[108] That is, they are Covered Taxes which are taken into account in determining the ETR for the jurisdiction.
[109] See Wardell-Burrus, 'Should a Foreign Tax Credit be given for QDMTT?', above n 33, 1656-1657; See further Heydon Wardell-Burrus, 'Pillar Two and Developing Countries: STTR and GloBE Implementation', 51(2) *Intertax* 118 (2023), Part II.

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Four Options for Priority Ordering Rules

	QDMTT applies before CFC Rules	CFC Rules apply before QDMTT
All CFC Taxes are allocated	1. CIT of Const. Entity 2. QDMTT 3. CFC (STR) 4. CFC (PTR) 5. IIR 6. UTPR Minimum Tax	1. CIT of Constituent Entity 2. CFC (STR) 3. CFC (PTR) 4. QDMTT 5. IIR 6. UTPR Minimum Tax
STR CFC Taxes are allocated	1. CIT of Const. Entity 2. QDMTT 3. CFC (STR) 4. IIR 5. UTPR Minimum Tax 6. CFC (PTR) Additional Tax	1. CIT of Const. Entity 2. CFC (STR) 3. QDMTT 4. IIR 5. UTPR Minimum Tax 6. CFC (PTR) Additional Tax

* Where a QDMTT fully covers the GloBE top-up tax for the jurisdiction, the minimum tax is only that imposed within the dotted-line box. All taxes outside the dotted-line box are additional (and there is no IIR or UTPR).
******The above does not show 'source taxes' which apply ahead of the CIT of the Constituent Entity (e.g. withholding taxes), nor do they show non-Covered Taxes (which are always additional).

The fundamental question for the Inclusive Framework is which of these four ordering rules do they want the GloBE Rules to produce? The outcome will be determined by answering whether (a) the QDMTT can (or will) apply with priority over CFC Rules and (b) CFC Taxes which assert primary taxing rights (where the additional tax arises due to expense allocation) will be allocated under the GloBE Rules. I have written separately arguing that the QDMTT should (at least) be able to apply ahead of CFC Taxes. I do not repeat those arguments here. For present purposes, it is sufficient to note that the question has not yet been determined and therefore both possibilities are considered.

4.3. The QDMTT applies ahead of CFC Taxes

If the QDMTT applies ahead of CFC Regimes (left hand side of the above table), then the allocation of CFC Taxes will only directly impact the amount of IIR and UTPR which might fall due. Where there is an applicable QDMTT, it should generally be expected to match the IIR liability which would otherwise arise

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and there will not be any further IIR or UTPR.[110] The GloBE minimum tax is imposed solely by reference to the Corporate Income Tax of the Constituent Entity and the QDMTT (this is shown by the dotted-line box). Any CFC Tax which is due will be in addition to these amounts and it would not matter how it was allocated under the GloBE Rules. Accordingly, one might think that the allocation mechanism would be irrelevant if the QDMTT applied ahead of the CFC Taxes. However, this analysis is misleading.

The allocation mechanism remains important because of the impact it has on the *incentive* for states to adopt a QDMTT. Consider the case where the allocation mechanism allows for CFC Taxes asserting primary taxing rights to apply ahead of the IIR/UTPR. This is the top left quadrant of the priority ordering rules table above. In such a case, a low tax state can improve its competitive position by not adopting a QDMTT. This is because if the low tax jurisdiction adopts a QDMTT, then the MNE operating in that jurisdiction is subject to the full QDMTT and the CFC Tax with respect to that jurisdiction (that is, the CFC Tax would be additional). However, if the low tax jurisdiction does not adopt a QDMTT, the MNE will be subject to less overall tax. This is because the CFC Taxes which would have applied in addition to the QDMTT would now apply in priority to the IIR and UTPR. The allocation of these taxes to the undertaxed jurisdiction will decrease the amount of IIR and UTPR which will apply (potentially to nil). Accordingly, investments in states which do not impose a QDMTT could be subject to a lower amount of total tax than investments in states with a QDMTT.

It might be thought that this problem would be resolved by the CFC regime giving a tax credit for the QDMTT which was imposed.[111] It could be assumed that this would increase the tax credits under the CFC regime and therefore produce a corresponding decrease in the amount of CFC Tax which would be imposed. However, it is very important to note that this would not work if the limiting factor for the Parent entity was a limitation on the use of foreign tax credits. Put differently, it is not enough for the Parent entity to be entitled to the foreign tax credit, it must be able to use it. Accordingly, even if the GILTI regime did give credits for the QDMTT, any MNE in an excess foreign tax credit position would not be benefited by these additional credits. Such MNEs would be able to achieve lower total taxation on investments in states without a QDMTT than those with a QDMTT.

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[110] Technically this is not required (and could happen if the QDMTT and IIR operate under different accounting rules). The amount of any QDMTT is subtracted from the IIR or UTPR amount which would otherwise arise. However, the QDMTT is generally expected to completely remove any IIR or UTPR with respect to the jurisdiction.

[111] I have previously argued that priority for the QDMTT over CFC Regimes could be achieved by the GloBE Rules refusing to take into account CFC Taxes that do not give a tax credit for the QDMTT. See Wardell-Burrus, 'Should a Foreign Tax Credit be given for QDMTT?', above n 33, 1655.

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This outcome needs to be compared to a case where the GloBE Rules do not give priority to CFC regimes imposing primary taxing rights (that is, the bottom left quadrant of the priority ordering table above). In such a case, the low tax state has a stronger incentive to adopt a QDMTT. This is because any assertion of primary taxing rights through a CFC regime will always impose tax in addition to the minimum amount required under the GloBE Rules. This will occur regardless of whether the minimum is imposed under the QDMTT, IIR or UTPR (and therefore might as well be collected by the undertaxed jurisdiction itself).[112] In fact, this could even create a further positive incentive to adopt a QDMTT if the US Parent is entitled to a foreign tax credit for QDMTT paid in the CFC jurisdiction but would not be entitled to a foreign tax credit for any IIR or UTPR paid with respect to that jurisdiction.[113]

It follows from the above that *if the QDMTT applies in priority to CFC Rules,* the allocation of CFC Taxes should generally be irrelevant where a QDMTT has already been adopted. However, it will matter both to cases where a QDMTT has not been adopted in a low tax state and to the incentives on low tax states on whether or not to adopt a QDMTT. Low tax states have a stronger incentive to adopt a QDMTT if the GloBE Rules do not allocate CFC Taxes asserting primary taxing rights over income allocated to a foreign constituent entity. If CFC Taxes imposing primary taxing rights are allocated to low tax jurisdictions, they will have a competitive incentive not to adopt a QDMTT.

4.4. CFC Taxes apply ahead of the QDMTT

The alternative possibility is that CFC Taxes apply ahead of the QDMTT (the right-hand side of the priority ordering table above).[114] In this case, the impacts are arguably the opposite in the sense that the allocation rule chosen will impact the amount of tax paid but does not substantially impact the incentives for low taxed jurisdictions to adopt a QDMTT. However, it will impact the incentives to raise the ETR for the jurisdiction to 15% under the regular corporate income tax.

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[112] Unfortunately, it is not quite so simple as to say there is no incentive not to adopt a QDMTT. There could be cases where the imposition of the QDMTT would still be a marginal increase in the total taxes paid by the MNE.

[113] It should be noted that this effect would only arise if the US MNE is not in an excess foreign tax credit position without taking into account any foreign tax credits for amounts of QDMTT.

[114] In this case I am assuming that applications of the QDMTT will take into account amounts of CFC Taxes in the numerator of the ETR calculation *and that* the CFC regime itself does not give a tax credit for amounts of CFC Tax paid. If the CFC regime also took into account the QDMTT paid (that is, gave a tax credit for QDMTT), it is possible to generate a 'feedback loop', whereby the CFC Regime and the QDMTT effectively try to credit one another. For further analysis on this problem and the accompanying 'spiral effect' and 'cliff effect', see Wardell-Burrus, 'Should a Foreign Tax Credit be given for QDMTT?', above n 33, 1652-1654.

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If the CFC jurisdiction has adopted a QDMTT, then any limitations on the allocation of CFC taxes will determine how much of the additional tax is received by the parent jurisdiction rather than the jurisdiction of the Constituent Entity. If the GloBE Rules accept the allocation of any CFC Tax (including where the parent is asserting primary taxing rights), then the parent jurisdiction will receive a greater amount of the taxes imposed. Effectively, a greater portion of the minimum tax amount would be paid to the parent jurisdiction over the constituent entity jurisdiction compared to a design under which the allocation of CFC Taxes is limited to where the parent jurisdiction is exercising secondary taxing rights. This could have a potentially large impact on the revenues raised by jurisdictions which adopt a QDMTT in response to the GloBE Rules.

The underlying logic of the QDMTT has been that it imposes tax which would rise regardless under the IIR (or UTPR). If the CFC Rules apply ahead of the QDMTT, the CFC Tax will effectively be operating as a 'parent company soak up tax', under which the parent jurisdiction can 'soak up' taxes which would otherwise be paid to the CFC jurisdiction under the QDMTT.[115] This reverses the ordinary relationship between corporate income taxes on subsidiaries and CFC Taxes.

As the QDMTT applies after the CFC Taxes (and is not credited by the CFC Regime), this structure does not provide a disincentive for adopting the QDMTT. This is because, once again, any taxes imposed under the QDMTT would have otherwise been imposed under the IIR or UTPR. However, the structure also creates an incentive for Parent jurisdictions to expand their CFC Rules.[116] This is because by increasing their CFC Taxes, the Parent jurisdiction can effectively soak-up taxes which would otherwise have been imposed under the QDMTT.[117] This means that where the undertaxed jurisdiction is taxed below the minimum rate, some portion of the increase in CFC Taxes on the parent entity would be borne by the undertaxed jurisdiction's revenue and not by the MNE itself.

There is also a question as to whether this creates an incentive for undertaxed jurisdictions to increase their regular corporate income tax. Such jurisdictions may recognize that their QDMTT will not apply

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[115] It should be noted that these are not the same amounts (that is, the 'soak up' is not dollar-for-dollar. This is because any CFC Tax is 'diluted' as a result of the SBIE mechanism (see above). Nevertheless, any increase in the CFC Taxes in the ETR numerator will decrease the top-up which would otherwise arise under the QDMTT.

[116] Alternately, one can think of this as reducing the disincentive for adopting a CFC regime.

[117] As per the above, this is not a dollar-for-dollar 'soak up'. In effect, the detriment of expanding the CFC regime is decreased because part of the additional tax amount would have been paid anyway under a GloBE top-up tax. I have written separately on the expanded use of CFC regimes as a countermeasure to low tax states seeking to shift from reliance upon a corporate income tax to a QDMTT. See Heydon Wardell-Burrus, 'State Strategic Responses to the GloBE Rules', *Oxford Centre for Business Taxation Working Paper 22/21,* (available on SSRN at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4291190), section 4.6.

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ahead of the CFC Tax while their corporate income tax will. However, this will only apply to the extent that the CFC tax regime allows a credit for the corporate income tax to be used against the CFC tax liability where they would not allow a QDMTT. This, of course, depends upon whether or not the CFC regime is asserting primary taxing rights or secondary taxing rights. To the extent that the parent jurisdiction is asserting secondary taxing rights, the jurisdiction of the undertaxed entity can still go first by increasing their regular corporate income tax.[118] However, to the extent that the Parent jurisdiction is asserting primary taxing rights, there is nothing that the jurisdiction of the constituent entity can do to claim these revenues itself in priority to the parent jurisdiction.[119] Of course, the parent jurisdiction can currently assert primary taxing rights in exactly this way (and, in the case of the US, it does). However, as noted above, part of the cost of asserting these primary taxing rights would now be borne by the CFC jurisdiction's revenue due to a reduction in the QDMTT which would otherwise have been imposed.

4.5. An Assertive Approach to allocating CFC Taxes

The above analysis shows that the key question with respect to the allocation of CFC Regimes imposing primary taxing rights is whether the GloBE Rules are concerned with creating the incentives for the jurisdiction of the Constituent Entity to impose the minimum level of taxation. If the Inclusive Framework's objective is only to ensure that a minimum level of tax is paid by the MNEs (but they are indifferent to which jurisdiction it is paid), then it may choose to allocate CFC Rules imposing both primary and secondary taxing rights.

If, however, the Inclusive Framework is concerned about creating full incentives for the jurisdiction of the Constituent Entity to collect the minimum level of tax itself, then there are strong reasons why they would seek to limit the allocation of CFC Taxes to cases where the Parent entity is asserting secondary taxing rights. If this were the objective, then allowing the QDMTT to apply ahead of CFC Rules and only allocating CFC Taxes on secondary taxing rights would be the best option for achieving that objective. This is the bottom-left quadrant of the above table. This would be an 'assertive' approach which was not deferential to CFC Tax Regimes but, instead, asserted priority ordering rules to achieve the GloBE Rules' objectives. Those priority rules would ensure that CFC Taxes as a result of asserting primary taxing rights in the parent

[118] However, this response would be inconsistent with the low tax jurisdiction obtaining the benefit of the substance-based income exclusion (SBIE). See further Wardell-Burrus, 'Pillar Two and Developing Countries: STTR and GloBE Implementation', above n 109, Part II (Proposal 1).
[119] This is, of course, exactly what it means for the CFC regime to be asserting primary taxing rights.

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jurisdiction[120] were always imposed as additional taxation and did not (a) reduce the tax which would be received by the constituent entity jurisdiction or (b) create a competitive incentive for the constituent entity jurisdiction not to adopt a QDMTT.

One can think about this as a question of 'deference' to the CFC Rule. A purely deferential approach would be to accept that the restriction on allocating CFC Taxes is predominantly formal. On this view, any CFC Taxes would be accepted and granted priority over (at least) the IIR and UTPR. The alternative view is that the GloBE Rules can legitimately put substantive limitations on what kinds of CFC Taxes will be given priority over the GloBE top-up taxes. While the Inclusive Framework could theoretically agree any limitations it chose on the CFC Taxes to which it is willing to give priority over the GloBE taxes, the most obvious example are cases where the parent jurisdiction is asserting primary taxing over income which has been allocated to another jurisdiction under proper transfer pricing principles. It is worth taking a moment to consider what this means.

The GloBE Rules are designed to apply on a territorial basis taking into account transfer pricing. In other words, they are assumed to apply where profit has been *properly* allocated to each constituent entity within the MNE.[121] Accordingly, the allocation rules for CFC Taxes relates to a case where a parent jurisdiction is asserting primary taxing rights over a tax base which has been allocated to another jurisdiction under transfer pricing principles. It is denying the use of those tax credits on the basis that expenses which are deductible in the US are allocable to the CFC despite these expenses not being taken into account under a proper transfer pricing analysis.

It is worth noting that if the Inclusive Framework accepts that any CFC Tax can be allocated down for the purposes of the GloBE Rules, then it is not obvious that there would be any real limits on how expansive a CFC regime could be. There does not appear to be a (non-formal) limitation on the definition of a CFC Tax Regime and there is no qualification process like there will be for the QDMTT, IIR or UTPR. To give a

[120] In other words, the GloBE Rules would not defer to the CFC Rules where additional taxation arises in the Parent jurisdiction as a result of allocating expenses to foreign CFCs which are not recognized under the transfer pricing analysis.

[121] This seems to suggest that the GloBE Rules are intended to apply on top of a system under which the profits of the MNE have been allocated (albeit imperfectly) in accordance with where value has been created within the group. It is worth noting that despite the fact that it underlies the current tax system (and the system under the GloBE Rules), the notion of value creation has been challenged. See Michael Devereux and John Vella, 'Value Creation as the Fundamental Principle of the International Corporate Tax System', *European Tax Policy Forum*, 31 July 2018; Michael P. Devereux and John Vella, 'Are we heading towards a corporate tax system fit for the 21st century?' (2014) 35(4) *Fiscal Studies* 449, 463-468; Michael Devereux and John Vella, "Taxing the Digital Economy: Targeted or System-Wide Reform", 2018 (4) *British Tax Review* 387.

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potentially concerning example, several tax theorists have asserted that national welfare could be enhanced by only granting a deduction for foreign taxes (rather than a full tax credit).[122] Despite this, the international tax system currently operates on a tax credit system (albeit limited). If the GloBE Rules grant priority to any CFC Taxes, how would the rules respond to a state seeking to instate a deduction system for the foreign taxes of its own MNEs? This is a simple example but is designed to show that there is potentially more at stake than just the acceptance of currently existing CFC regimes.

4.6. Assertive Allocation Mechanism

If the Inclusive Framework determined that priority would not be given to CFC Taxes which are used to assert primary taxing rights, it could achieve this outcome through the allocation mechanism for CFC Taxes. The simplest way of doing so would be to adopt a cap on the allocation of CFC Taxes to foreign Constituent Entities. This cap would be calculated as the amount of CFC Tax which would have been imposed under the CFC regime if full tax credits were granted for all Covered Taxes on that income by the jurisdiction of the Constituent Entity. It would also need to include amounts of QDMTT if the Inclusive Framework decides that the QDMTT can apply ahead of CFC regimes. To the extent that a CFC regime imposed additional tax due to disallowing tax credits for Covered Taxes (or QDMTT) that additional tax liability would not be allocated to the subsidiary jurisdiction (and could either be counted towards the parent state or, if the Inclusive Framework chose, be treated as a non-Covered Tax).

In the context of the GILTI regime, this means would effectively mean that additional tax arising under the GILTI regime because of (a) the 20% haircut for foreign taxes and (b) the allocation of US expenses would not be allocated down to the CFC jurisdictions under the GloBE Rules. This would be the Inclusive Framework effectively saying that they would not treat a CFC Rule as a Covered Tax *to the extent that it did not recognize and credit Covered Taxes which are higher in the agreed priority order.* Again, this would in no way prevent a parent jurisdiction from imposing such taxes, it would simply insist on them being in addition to the minimum tax for the jurisdiction imposed under the GloBE Rules.

As a matter of process, this mechanism would proceed as outlined in the deferential approach above. However, it would involve an additional step. Once the amount of GILTI Tax had been allocated to the

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[122] This example may be of particular salience as a variety of authors have argued that an optimal CFC design would only grant a deduction for foreign taxes rather than a full credit. See, for example, Daniel Shaviro, 'Rethinking Foreign Tax Creditability', 63(4) *National Tax Journal* 709 and sources cited therein. This could be achieved by a mathematical equation which effectively converted the deduction into a foreign tax credit limitation. This is achieved by having a foreign tax credit limitation equal to the number of FTCs multiplied by the tax rate in the parent jurisdiction.

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jurisdiction, there would be an analysis of what the CFC Tax would have been had the CFC Regime granted tax credits for all Covered Taxes on the relevant income. This step would involve taking the 'pre-foreign tax credit tax liability' for each jurisdiction (from Step 2, see section 3.2) and subtracting all Covered Taxes which had been paid with respect to the income generating that amount. The result would determine a cap on the amount of CFC Tax which could be allocated under the GloBE Rules. The GloBE Rules would be dividing the CFC Tax into a component imposing secondary taxing rights (allowed under the cap) and primary taxing rights (the amount excluded due to the cap).

5. A transitional allocation mechanism

The above analysis has set out two methods of allocating the CFC Taxes – a deferential approach and an assertive approach. One thing that these two mechanisms have in common is that they are relatively complicated. Both cases involve calculating the US CFC Tax with respect to each CFC separately and relying upon US tax principles. While this article argues that these mechanisms would provide the 'correct' allocation mechanism depending upon the objectives of the Inclusive Framework, it is important to recognize that that there is a high-premium to be placed on simplified rules. This is particularly the case for the initial years of the GloBE regime. Accordingly, it may be considered appropriate to adopt a transitional rule to deal with the GILTI allocation for the early years of the GloBE Regime.

A simplified transitional rule would recognize that the GloBE Rules are complicated and there will be significant efforts required in order to build appropriate compliance systems for large MNEs. As a result, it may be considered prudent to defer the 'proper' GILTI allocation mechanism until taxpayers and states are more accustomed to the GloBE Rules. This would, of course, involve a trade-off of accuracy for simplicity for the initial years. However, it is clear that the Inclusive Framework has been willing to consider simplified transitional rules with respect to the safe harbors.

A second key reason to consider a simplified transitional rule is that there is a possibility that the GILTI regime could be amended in 2025 to apply on a country-by-country basis. If the US were to amend GILTI to the point that the Inclusive Framework were willing to treat it as a qualified IIR, it would no longer be necessary to apply an allocation mechanism for it as a CFC Tax. Accordingly, there may be an opportunity to save on complexity and compliance cost by adopting a time-limited transitional rule. However, such a rule should be time-limited particularly if there is a risk that it could provide advantages to US MNEs (when compared to a proper allocation). If the simplified rule were both generous to US MNEs and not time-

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limited, there would be a significantly reduced incentive for the US to align the GILTI regime with the GloBE Rules.

A full design for a transitional allocation mechanism is beyond the scope of this article. Accordingly, this section is limited to a few observations. First, a transitional allocation mechanism would sensibly be based upon the calculations in the GloBE Rules. There would be an important question as to whether the allocation mechanism attempted to allocate the tax to CFCs based upon the ETR of the individual CFC as a Constituent Entity or whether it would be allocated based upon the ETR of the jurisdiction.

Second, there is an important question regarding how to calculate the total amount of CFC Tax under a simplified transitional rule. A simplified 'deferential' approach would involve treating the total CFC Tax under a 'with' and 'without' calculation to determine the additional tax arising from the CFC Tax Regime. A simplified 'assertive' approach could take the total pre-foreign tax credit tax liability for the GILTI basket and then subtract the total amount of creditable foreign taxes (that is, the amount prior to the 20% haircut and foreign tax credit limitation).

Third, there would be a question as to whether the amount of SBIE in the relevant CFC or jurisdiction would be taken into account. As noted above, both the GILTI regime and the GloBE Rules have a 'substance-based carve-out'. If the transitional rule were willing to treat the GILTI carve-out (NDTIR) as roughly equivalent to SBIE (despite the fact that NDTIR offers no carve-out for payroll expenditure), then the allocation could be made in proportion to the top-up tax amount for each jurisdiction. If the transitional rule were not willing to treat NDTIR as equivalent to the SBIE, the allocation could be proportionate to the amount of additional tax which would be required to raise the ETR for the jurisdiction to 15%. This could involve the allocation of CFC Tax to jurisdictions which have no Excess Profit (resulting in 'waste' of the CFC Tax).

Fourth, the Inclusive Framework would need to determine whether or not the CFC Tax would still be allocated to jurisdictions which have adopted a QDMTT. If the CFC Taxes always apply before the QDMTT, this is simple – yes. If the QDMTT applies ahead of CFC Taxes, allocating CFC Taxes to the QDMTT would 'waste' the CFC Tax (that is, the allocation would not reduce the amount of GloBE top-up tax). While this would be generally consistent with the Inclusive Framework decision for the QDMTT to apply ahead of CFC Rules, if the CFC Tax Regime were giving a credit for the QDMTT itself, it could involve allocating CFC tax to a jurisdiction with respect to which CFC Tax is not fundamentally arising. Furthermore, it runs the

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risk of reducing the incentive to adopt a QDMTT (as the allocated CFC tax would be in addition to the QDMTT amount).

A time-limited simplified transitional rule would likely be attractive to the Inclusive Framework if it thought that there were real prospects that the US would be able to reform GILTI to the extent that it could be treated as a qualified IIR within a reasonable time window. However, when designing such a rule the Inclusive Framework is likely to be concerned about reducing incentives to align the GILTI regime to the GloBE Rules if there is a view that it can retain preferable treatment under an allocation rule which it could seek to extend.

6. Conclusion

The treatment of the GILTI regime under the GloBE Rules is a complicated matter. If GILTI is treated as a CFC regime (and not a qualified IIR), then there is an important issue of how the additional taxes arising as a result of the GILTI regime are to be allocated to subsidiary jurisdictions. If MNEs have a choice with respect to which methodology to apply, they are likely to make that choice in a way which minimizes the relevant amount of tax. Furthermore, if there is no clarity in a required methodology, there is a risk that different jurisdictions could take different approaches when applying the IIR or UTPR. In addition to producing a large compliance expense, this could produce different outcomes under the application of the GloBE Rules.[123] The GloBE Commentary recognizes that there needs to be a 'common methodology' which would apply with respect to 'specific country regimes'.[124] The above has effectively set out two fundamental methodologies to allocate the GILTI regime for consideration.

The first GILTI allocation methodology discussed in this paper adopts a 'deferential approach'. It seeks to reallocate all of the additional taxation from the GILTI regime down to lower CFC jurisdictions. However, even under a deferential approach, a proper allocation would require addressing expense allocation in a way that properly addresses the allocation of expenses to particular CFCs. The proposed methodology operates by allocating the disallowance of tax credits under the GILTI regime to different CFCs by using separate baskets for different jurisdictions. While more conceptually pure, there could be strong calls for simplification which may weigh against the Inclusive Framework adopting this approach.

[123] It should be noted that this ought not create 'double taxation'. Some states would simply produce a calculation with larger or smaller amounts of top-up tax. However, regardless of different approaches adopted by different states, the MNE should not be subject to a greater amount of taxation than if every state adopted the least generous allocation mechanism.

[124] This is stated with respect to the allocation of tax between a permanent establishment and its head office but it is equally applicable to CFC Taxes. See Commentary to the GloBE Rules, above n 56, Art. 4, paragraph [54].

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The second discussed GILTI allocation methodology adopts an 'assertive approach'. This proposal would be attractive to the Inclusive Framework if it decided that the GloBE Rules should take a more active role in determining the ordering rules under the global minimum tax. The approach would effectively operate by limiting the allocation of GILTI (and other CFC Taxes) to the extent that the CFC Rule did not allow a taxpayer to use foreign tax credits for Covered Taxes in the Constituent Entity jurisdiction. The section also set out the interaction of this question in the context of a separate (but also crucial) policy question – whether the QDMTT will apply ahead of CFC Regimes or not.

Ultimately, it will be a matter for the Inclusive Framework to determine whether it wants to take a deferential or assertive approach (either under the above methodologies or simplified versions of them). However, it is helpful to note how these respective approaches map onto the potential objectives of the project. As outlined above, there is a fundamental question as to whether the GloBE Rules have an objective of creating the incentives for the minimum level of tax to be collected in the Constituent Entity jurisdiction (to which the profits have been allocated under transfer pricing rules). This is an importantly different objective to simply ensuring that a minimum level of tax is paid with respect to each jurisdiction in which the MNE operates (which is indifferent as to which jurisdiction gets the revenue). The assertive approach is more consistent with an objective of creating the incentives for the minimum level of tax to be collected in the Constituent Entity jurisdiction.

The assertive approach would only recognize CFC Taxes to the extent that those CFC Taxes give priority to Covered Taxes recognized by the GloBE Rules. This ensures that any CFC Taxes which do not accept the priority order proposed by the Inclusive Framework must be applied in addition to the global minimum tax. This would preserve the strong incentive to adopt the QDMTT for low tax jurisdictions to which the profit is allocated under the GloBE Rules.

It is beyond the scope of this paper to provide a proper analysis of alternative methodologies which have been suggested for allocating the GILTI tax as a CFC Tax. However, readers ought to be aware that alternative methodologies have been put forward. First, there is a 'simplified approach' outlined in the New York State Bar Association Tax Committee Report of July 2022[125] (though this does not attempt to grapple with several sources of complexity). Second, the American Chamber of Commerce in the Netherlands made a submission to the Dutch Government's Pillar Two consultation which sets out three

[125] See NYSBA Taxation Committee Report, above n 48, footnote 88.

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alternative methodologies in an Annex.[126] The submission appears to recognize that the primary proposal will not produce the correct allocation in all circumstances but could provide 'a practical midpoint'.[127]

The interaction between the GloBE Rules and the US CFC Regimes is both a technical and political challenge. The Inclusive Framework decisions with respect to the treatment of these regimes cannot be isolated from the politics of the broader Pillars negotiations (and broader geopolitics as well). Despite this fact, it remains important to consider the technical interactions and the likely impact that different approaches will have on the operation of the GloBE Regime and whether it achieves its objectives. Ultimately, these issues will need to be resolved by the Inclusive Framework in a way that balances their (potentially contentious) objectives, political realities and design ideals. This task is made harder by the fact that the interactions between the world's various corporate tax systems form a complex system which renders accurate predictions of the likely impacts of substantial changes exceedingly difficult. Despite this, decisions still need to be made. This paper has sought to provide some guidance on several key factors which ought to be considered.

[126] See 'AmCham Netherlands Responds to Pillar 2 Consultation', *Tax Analysts,* 2 December 2022.
[127] AmCham Netherlands Submission, above n 126, 7.

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