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Australia Finds GILTI Not a CFC Regime Eligible for a Pass From Its Anti-Hybrid Regime

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Anti-hybrid rules by their very nature depend on an analysis of the tax laws of a foreign country. For example, §267A requires a U.S. taxpayer to determine whether a payment to a related foreign person is included in such person's income or is subject to tax under the tax law of the country where such person is tax resident, or whether the related foreign person is allowed a deduction with respect to such amount under the tax law of the country in which it resides. This analysis may not be straightforward, which is one reason that the United States has traditionally eschewed basing its tax rules on foreign tax law.[1]

Australia, like the United States, adopted anti-hybrid rules in response to Action Item #2 of the OECD's original Base Erosion and Profit Shifting (BEPS) project. In determining whether an item paid to a non-Australian is subject to tax in the payee's home country, Australia's rules generally treat amounts paid to a controlled foreign corporation (CFC), as defined for Australian tax purposes, as included in the income of the CFC's shareholder; this will be referred to as the CFC Exception. Based on this, one might have thought that if an amount payable to a CFC of a U.S. person was subject to tax under the GILTI rules of §951A,[2] this would be enough to conclude that the amount was not subject to Australia's anti-hybrid regime under the CFC Exception. But in a recent ruling, the Australian Tax Office (ATO) ruled to the contrary.[3]

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[1] Section 267A is one exception to this traditional U.S. approach. There are a few others: See the last sentence of this article. For a complete analysis of these issues, see Erika W. Nijenhuis and John D. McDonald, *Foreign Tax Law: Its Relevance in Resolving U.S. Tax Law Issues*, Taxes at 39 (Apr. 1, 2013).

[2] Added by the Tax Cuts and Jobs Act (TCJA), Pub. L. No. 115-97, tit. I, §14201(a) (Dec. 22, 2017).

[3] TD 2022/9 (June 29, 2022). The examples ruled upon by the ATO were:

> Example 1 — identification and calculation of the deduction/non-inclusion outcome US Co is a U.S.-resident company that has numerous wholly-owned foreign subsidiaries, including Aus Co (an Australian-resident company) and Foreign LP, a limited partnership which is a reverse hybrid entity (as a result of an election to be treated as an association taxable as a corporation for U.S. federal income tax purposes). Aus Co makes a deductible payment of $100 to Foreign LP, which is not taxed in Foreign LP's formation country because the formation country treats US Co as the liable entity in respect of Foreign LP's income and profits. The payment of $100 is also not taxed in the hands of US Co because, for U.S. federal income tax purposes, Foreign LP is treated as a foreign corporation and the liable entity in respect of Foreign LP's income and profits. Section 951A applies to US Co with respect to its interests in its foreign subsidiaries, including Foreign LP. The payment of $100 from Aus Co to Foreign LP is taken into account in

Australia's CFC Exception applies only if the amount paid by the Australian party is included in the tax base of the CFC shareholder ''under a provision of a law of a foreign country that corresponds to section 456 or 457 of the Income Tax Assessment Act,'' referring to the relevant portions of Australia's CFC regime.

The ATO was of the view that GILTI did not ''correspond'' to the Australian CFC rules. The ATO examined the meaning of the word ''correspond,'' stating that ''A provision will correspond with another provision if it answers it in character and function, is similar in purpose, prescribes the same thing to be done, and is designed to produce the same result.'' The ATO then concluded that GILTI did not correspond to Australia's CFC rules in a passage worth citing in full:

> At its core, the objective of section 951A (which operates in conjunction with section 250 and subsection 960(d)) is to impose a minimum rate of tax on deemed high or above-normal returns of CFCs. In contrast, sections 456 and 457 are not inclusion provisions for a minimum tax regime. The purpose of sections 456 and 457 is to deter tainted income from being shifted offshore for the aim of avoiding or deferring Australian tax. In line with this purpose, attributable income of a CFC included in the assessable income of an Australian-resident controller is not subject to any further reduction or concession, other than the allowable deductions to which the controller would be entitled outside of Part X for their own expenditure.

The ATO's understanding of GILTI is incorrect, for the reasons described below. But putting aside whether it was correct or not, it is important to note how difficult it is for an agency or court of one country to understand the tax laws of another country in context. If the ATO's erroneous decision proves anything, it is simply that countries should exercise great care in attempting to parse foreign law, and avoid hubris in analyzing issues that are, well, foreign to them.

The ATO concluded that GILTI is a form of minimum tax. It is not. The characterization of GILTI as a minimum tax has been fairly common in OECD and international circles, and occasionally even in U.S. government circles. One reason for this may be the unfortunate acronym adopted in §951A by Congress: Global Intangible Low-Taxed Income. But GILTI is not limited to intangible income or to low-taxed income, and is not a minimum tax on either. Like subpart F, of which it is an (ungainly) part, GILTI applies across the board to all CFCs, regardless of whether they operate and earn income in high-tax or low-tax environments, and regardless of whether the income in question derives from intangibles.

To mirror the ATO's language, ''at its core'' GILTI is simply the acceleration of active (non-subpart F) dividend-equivalent income that was deferred until repatriation prior to the adoption of GILTI. (Unlike many countries, the United States has never had a territorial regime for active income or a participation exemption for dividends from active foreign subsidiaries.) GILTI is taxed at a lower rate of tax[4] than the rate that applies to subpart F income, because it was a compromise for loss of deferral; in effect, the tax is payable earlier than it would be under a classic real-

calculating whether Foreign LP has tested income or a tested loss amount, which in turn is taken into account in determining the section 951A inclusion amount for US Co.

Example 2 — identification and calculation of dual inclusion income

Aus Co 1 and Aus Co 2 are Australian-resident companies that are wholly-owned subsidiaries of US Parent, a U.S.-tax resident corporation. US Parent is the 100% shareholder of Aus Co 1. In turn, Aus Co 1 is the 100% shareholder of Aus Co 2. Aus Co 1 (head company) and Aus Co 2 (subsidiary member) are members of a tax consolidated group for Australian tax purposes. An election was made for Aus Co 1 to be 'disregarded' for U.S. federal income tax purposes. As a result, the income derived by, and all of the deductible payments made by Aus Co 1 are treated as income and expenses of US Parent for U.S. federal income tax purposes, with the exception of any transactions directly between Aus Co 1 and US Parent, which are disregarded. The election is limited to Aus Co 1. Aus Co 2 is treated as a foreign corporation of US Parent for U.S. federal income tax purposes. Aus Co 1 makes a $100 deductible payment to US Parent which gives rise to a hybrid payer mismatch amount under Subdivision 832-D. Aus Co 2 has income from sales to third parties that is included in the assessable income of Aus Co 1 (as head company of the tax consolidated group) and regarded as subject to Australian income tax under section 832-125. Section 951A applies to US Parent with respect to its interest in Aus Co 2 (and any other foreign subsidiaries that are treated as foreign corporations for U.S. federal income tax purposes). As part of the calculation of the section 951A inclusion amount for US Parent, the income and expenses of Aus Co 2 are taken into account.

[4] The lower rate of GILTI tax applies only to shareholders that are corporations.

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ization regime. GILTI was not meant to operate, and does not in fact operate, as a minimum tax on low-taxed foreign income. The reverse is in fact true — GILTI is simply a new variation of the longstanding U.S. system of taxing even active foreign earnings of CFCs to U.S. controlling shareholders, subject to a foreign tax credit.

The ATO's notion that GILTI is a form of minimum tax was based in part on its reading of a passage from the legislative history, read out of context without taking into account other important aspects of U.S. tax law. The ruling cited this passage from a Senate Finance Report that quickly garnered fame in U.S. tax circles for its ambiguity and ignorance of the operation of U.S. foreign tax credit rules:

> As a result of the [section 250 deduction], and with respect to domestic corporations. . .the effective U.S. tax rate on GILTI is 10 percent for taxable years beginning after December 31, 2017, and before January 1, 2026. Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTl, at which no U.S. residual tax is owed by a domestic corporation is 12.5 percent. If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 10 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 12.5 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10 percent and 12.5 percent. *At foreign tax rates greater than or equal to 12.5 percent, there is no residual U.S. tax owed on GlLTI, so that the combined foreign and U.S. tax rate on GILTl equals the foreign tax rate*.[5]

Reading only the last sentence above, a casual observer not versed in the intricacies of the U.S. foreign tax credit rules would assume that GILTI simply does not apply where the effective rate of foreign tax on the CFC is above 12.5% (13.25% as amended). From this, one might conclude that GILTI is some sort of minimum tax. But as commentators swiftly pointed out, this passage itself is incorrect insofar as it suggests that GILTI does not apply where the foreign tax rate is 13.25% or higher. The foreign tax credit is based solely on U.S. tax principles and is limited in several ways, including by limiting the credit to what U.S. tax rules treat as foreign-source income and by allocating deductions between U.S.- and foreign-source income in a manner that stacks the deck in favor of disallowance of a credit for actual foreign taxes. Moreover, GILTI is calculated on an annual basis without carryovers. CFCs that pay tax at home at rates far in excess of 13.25% can be subject to additional tax under GILTI. GILTI can also apply to companies that operate at a loss.

Even assuming for the sake of argument that GILTI is viewed as a minimum tax, the ATO ruling does not make clear *why* a minimum tax cannot "correspond" to Australia's CFC rules. The definition of a CFC regime in the OECD's Pillar Two model rules seems clearly to encompass GILTI. That definition of a CFC regime is: "a set of tax rules (other than an IIR) under which a direct or indirect shareholder of a foreign entity (the. . .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." This definition clearly encompasses GILTI.

The ATO's decision was also based in part on a misunderstanding of the §250 deduction. The ATO appears to have viewed §250 as a special tax benefit and a component of a minimum tax, citing to legislative history noting that without a reduced rate of tax on GILTI, the competitiveness of U.S. corporations would suffer. But the competitiveness issue needs to be understood in light of the U.S.'s historic and continuing insistence on taxing all dividends from all CFCs, even if paid out of active income, subject only to a (limited) foreign tax credit — something most other countries do not do.[6] As long as that extraordinary assertion of jurisdiction was limited by the realization principle, such that the tax liability could be deferred until repatriation, this was manageable from the point of view of competitiveness, because it operated in many cases as a functional exemption equivalent for active income of CFCs. But once deferral was repealed by the TCJA (for everything but a sliver of tangible asset basis), taxing all of this income at the full corporate rate would indeed have put U.S. corporate taxpayers in a far worse position than their foreign counterparts. So again, GILTI is nothing more than an acceleration of the tax, at a lower rate, on income over which the United States has always exercised taxing jurisdiction.

At bottom, the ATO ruling seems predicated on a finding that GILTI doesn't "look like" the Australian CFC regime, and thus does not "correspond" to the Australian regime as required by the CFC Exception. In one sense, this is certainly true. GILTI does not

[5] U.S. Senate Committee on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Prt. 115-20, at 370–380 (Dec. 2017) (emphasis added). As the ATO recognized, the actual numbers changed when the base rate of corporate tax was increased from 20% to 21% in final passage. Similar language, using the correct rates, was included in the Conference Report to the final act.

[6] Many countries provide a territorial exemption for active income of branches and a participation exemption for dividends from active foreign subsidiaries.

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look or feel like a typical CFC tax found in other jurisdictions, including Australia. But that is because GILTI is far broader, layered on top of the U.S. subpart F rules that the ATO would certainly have found to correspond to the Australian CFC rules. Rather than try to buttonhole the GILTI rules into a category of rules they do not correspond to — which lack of correspondence is attributable to the fact that the U.S. tax system sweeps more broadly than most — the ATO should have asked whether an equivalent income inclusion result, consistent with the underlying purpose of the anti-hybrid rules, was achieved.[7]

It is difficult enough for an agency or court to understand the nuances of foreign law, without further complicating matters by attempting to determine whether a given foreign tax law ''corresponds'' to a domestic law. In many cases, foreign tax law simply won't correspond to domestic law, because the foreign regime is predicated on wholly different foundational principles. At least in complex cases, courts and governmental agencies do not have the depth of experience to grasp the manner in which different foundational principles lead to different tax rules. It was for this reason that the IRS threw in the towel many years ago when it came to the classification of foreign entities as corporations or partnerships. Despite a 1999 OECD report on partnerships urging member states to respect the entity classification in the taxpayer's own state of residence,[8] most countries continue to apply a ''similarity'' analysis to determine the classification of a foreign entity. This practice is especially unfortunate because many countries purport to apply a ''legal personality'' test that has no counterpart, and thus no significance, in the law of the United States and several other countries.[9] This practice leads to the unnecessary proliferation of hybrid entities, to no good purpose, ironically increasing the number of disputes over anti-hybrid provisions.

It would not come as a surprise if the U.S. Treasury Department and the IRS took objection to the ATO anti-hybrid ruling. But in view of the recently finalized foreign tax credit regulations' jurisdictional ''attribution'' requirement,[10] this would be the pot calling the kettle black. Those regulations overturned years of precedent under which the determination whether a foreign tax was a creditable income tax was based on a facts and circumstances analysis. In the place of that regime, the regulations adopted a strictly ''objective'' set of rules that essentially ask whether a foreign tax ''corresponds'' to the U.S. income tax. A good argument can be made that no foreign tax qualifies as a foreign income tax under these rules, which is exactly the result one would expect where one country tries to shoehorn another country's rules into its own without looking at the foreign country's tax system as a whole.

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[7] The author has not attempted to determine whether the first of the two examples cited by the ATO might have been covered by the subpart F rules, in which case the CFC Exception would have applied. There are not enough facts in the ruling to make that determination.

[8] OECD, *Issues in International Taxation No. 6, The Application of the OECD Model Tax Convention to Partnerships* (Jan. 20, 1999).

[9] *See* Kimberly Blanchard, *The Significance of Legal Personality*, Bus. Entities 4 (Mar./Apr. 2016).

[10] Reg. §1.901-2(b).

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