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Proposed Regulations on Global Intangible Low-Taxed Income (GILTI)

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On Sept. 13, 2018, the IRS released REG-104390-18, proposed regulations (the "Regs") related to Section 951A, Global Intangible Low-Taxed Income (GILTI), which was enacted in 2017 as part of the Tax Cuts and Jobs Act (TCJA). The Regs provide guidance for U.S. shareholders in certain foreign corporations to determine the amount of GILTI to include in gross income ("GILTI inclusion amount").[1] The Regs address the amount of GILTI inclusion and prescribe new pro rata share rules for determining a U.S. shareholder's GILTI inclusion for purposes of Section 951A.[2] The Regs are generally effective for tax years beginning after Dec. 31, 2017. This article provides an overview of the Regs and highlights important open issues regarding determination of a U.S. shareholder's GILTI amounts.

BACKGROUND

TCJA created a new category of foreign income loosely derived from "intangibles" that generally cannot be deferred (GILTI income).[3] GILTI income is treated in a manner similar to subpart F income, which in general is foreign-generated income that is taxed to certain U.S. owners of a foreign business. GILTI seeks to include in U.S. taxable income the low-taxed income of a controlled foreign corporation (CFC) that is not otherwise treated as subpart F taxable income under another section of the Code and that exceeds a "routine" (10 percent) return on the U.S. tax basis in a CFC's depreciable tangible assets.[4] GILTI is equal to the amount of a CFC's "net tested income," which exceeds the net deemed return on the foreign corporation's tangible assets (based on a percentage of qualified business assets, or QBAI less interest expense).[5]

Eligible C corporations are entitled to a tax credit for 80 percent of foreign taxes paid by their CFCs attributable to the GILTI amount. The amount of foreign taxes attributable to the GILTI amount is calculated by multiplying the U.S. Shareholder's "inclusion percentage" by the total foreign income taxes paid by such CFCs that are attributable to tested income. The inclusion percentage is the ratio of such U.S. Shareholder's GILTI amount divided by the relevant aggregate amount of tested income.

A deduction is available under section 250 for 50 percent of the GILTI inclusion inclusive of the "section 78 gross-up" on foreign taxes remitted.[6] At the new 21 percent corporate tax rates, this produces an effective tax rate of 10.5 percent on any GILTI inclusion (before taking into account any foreign tax credits). For tax years 2026 and later, the deduction is reduced to 37.5 percent of the GILTI inclusion plus any related Section 78 amount, producing an effective tax rate of 13.125 percent. The amount of the GILTI deduction is subject to limitation if the sum of such GILTI and foreign derived intangible income (FDII) exceeds its taxable income.

The Regs provide general rules and definitions around the calculation of tested income and loss, specified interest expense, treatment of domestic partnerships and their partners, and the treatment of the GILTI inclusion amount and adjustments to earnings and profits/basis. The Regs also include GILTI anti-avoidance rules. New reporting rules requiring the filing of Form 8992, U.S. Shareholder Calculation of GILTI, are also described in the Regs.

The Regs, however, do not address Section 250 and Section 960 (foreign tax credit). The Treasury announced that there will be additional regulations addressing these provisions.

NET TESTED INCOME

Net tested income excludes income that would otherwise be subpart F income under other existing provisions of the Code or would be excluded from subpart F via the high-taxed income exception under Section 954(b)(4). Income that would have been exempt from subpart F either under the active finance or active insurance exceptions (AFE) in Sections 954(h) and (i) is **not** excluded from the definition of tested income for GILTI purposes. Generally, unlike the high-tax exception for Foreign Tax Credit (FTC), the high-tax exception exclusion from GILTI is likely not available to foreign insurers for insurance and investment income that is excluded from subpart F pursuant to the AFE.

TESTED LOSS

Section 951A provides a coordination rule that is intended to deny a double benefit resulting from tested losses. Under that coordination rule, a tested loss CFC increases its earnings and profits by the amount of its tested loss for purposes of applying the subpart F current year earnings and profits limitation contained in Section 952(c)(1)(A) (the "tested loss add-back"). There is no indication that tested loss must offset tested income to be subject to this rule.

CONSOLIDATED GROUPS: AGGREGATE BASIS AND PRO RATA SHARE ALLOCATION

Generally, the Regs require a consolidated approach for determining a consolidated group member's GILTI inclusion. In several steps, a consolidated group aggregates and allocates tested losses, QBAI and specified interest expense. First, each member determines its tested income on a stand-alone basis. Then, the "GILTI allocation ratio" is determined based on each member's pro rata share of the total tested income of the consolidated group. Finally, shares of the consolidated group's total tested losses, QBAI and specified interest expense are allocated based on the "GILTI allocation ratio."

ANTI-AVOIDANCE PROVISIONS

The Regs provide a set of anti-abuse provisions. First, a "facts and circumstances" approach is required for allocating subpart F and GILTI income. Second, all transactions or arrangements that were undertaken with a principal purpose of reducing subpart F or GILTI inclusions may be disregarded. Third, there are two QBAI-specific anti-abuse measures:

- Specified tangible property is disregarded in computing a CFC's QBAI if the CFC (1) acquires the property with the principal purpose of reducing GILTI inclusion and (2) holds the property temporarily and as of at least one quarter-end. Property held for a less-than-12-month period that includes at least one quarter-end is treated as temporarily held and acquired with the requisite avoidance purpose.

- The Regs deny the benefit of stepped-up basis in specified tangible property transferred between related CFCs during the period before the transferor CFC's first GILTI inclusion year. As such, the transferee CFC's QBAI is computed without the increased basis—generally leading to a lower return on tangible property and, thus, a larger GILTI inclusion.

SOME OPEN ISSUES

While the Regs offer helpful guidance, the new law is very complex and there are some areas where taxpayers may still have questions or seek additional clarifications. The interplay between GILTI and the foreign tax credit provisions is complex, and taxpayers will appreciate further clarifications of that issue in subsequent guidance. GILTI income, for example, is in its own "basket" for foreign tax credit limitation purposes.

"Taxable income" for these purposes is computed after the net operating loss (NOL) deduction under Section 172. The NOL deduction is computed based on taxable income without regard to the Section 250 deduction mentioned previously. Taxpayers have been asking questions around the interpretation of the "without regard to" language in the above-mentioned provision. Does the NOL computation ignore just the current year Section 250 deduction? Or would it exclude a cumulative deduction for prior years as well in an NOL carryforward scenario?

TAKEAWAY

The Regs provide a start for taxpayers to interpret and apply the new GILTI provision. Yet, in the absence of completed IRS guidance, taxpayers still face uncertainty (and possibly opportunity). Taxpayers await clarification on multiple issues, many of which have been raised in comments submitted to the Treasury. Certainly, there is more to come on the GILTI front. Modeling exercise might be necessary in order to estimate the implications of GILTI/FTC/Subpart F interactions. ■

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ENDNOTES

1 A U.S. shareholder for these purposes is a domestic corporation that owns directly or indirectly 10 percent or more of the stock (by vote or value) of the foreign corporation.

2 Unless otherwise specified, all "Section" and "§" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder, all as in effect (or, in the case of proposed regulations, as proposed) as of the date of this article.

3 TCJA introduced a new category of income called GILTI under new Section 951A. The GILTI provision is effective for tax years beginning on or after Jan. 1, 2018.

4 A CFC is any foreign corporation of which U.S. shareholders own more than 50 percent of the vote or value. The required percentage U.S. ownership for CFC status is reduced to 25 percent if the foreign corporation is an insurance company.

5 A CFC's QBAI for a tax year means the average of its aggregate adjusted bases (for U.S. federal income tax purposes, as measured as of the close of each quarter of the tax year) in "specified tangible property" used by the CFC in a trade or business and for which a deduction is allowable under Section 167. "Specified tangible property" generally means any tangible property "used in the production of tested income." Tangible property used by a CFC in the production of tested income and income that is not tested income is treated as specified tangible property in the same proportion as the tested income produced "with respect to" the property bears to the total gross income produced "with respect to" the property. The adjusted basis in any property is determined by using the alternative depreciation system under Section 168(g) and by allocating the depreciation deduction ratably to each day during the period in the tax year to which the depreciation relates.

6 "Section 78 gross-up" requires that if a deemed paid foreign credit is claimed, the amount equal to the taxes deemed to have been paid must be included in the gross income of the domestic corporation. This gross-up income is treated as if it were a foreign dividend received by a domestic corporation.