A NEW TAX REGIME FOR C.F.C.'S: WHO IS G.I.L.T.I.?

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INTRODUCTION

The 2017 Tax Cuts and Jobs Act introduces a new tax regime applicable to controlled foreign corporations ("C.F.C.'s"). As discussed in detail below, Code §§951A and 250 will generally result in the following:

- A C.F.C.'s global intangible low-taxed income ("G.I.L.T.I.") will pass through to its "U.S. Shareholders" (a term broadened under the new law) as a current year income inclusion.
- In the case of a U.S. corporation (other than a regulated investment company or real estate investment trust), a deduction for foreign-derived intangible income ("F.D.I.I.") and G.I.L.T.I. will be allowed against its G.I.L.T.I. inclusion.

The G.I.L.T.I. regime is designed to decrease the incentive for a U.S. group to shift corporate profits to low-tax jurisdictions. In this way, it protects the new participation exemption regime[1] by preventing mobile intangible income from being used to reduce U.S. taxable income for the payer while preventing the payer's group from obtaining the benefit of the dividend received deduction for dividends from a C.F.C. that received G.I.L.T.I. As stated in the Conference Committee Report:

> Changing the U.S. international tax system from a worldwide system of taxation to a participation exemption system of taxation exacerbates the incentive under present law to shift profits abroad. Specifically, under present law, most foreign profits earned through a subsidiary are not subject to current taxation but will eventually be subject to U.S. taxation upon repatriation. Under the participation exemption system provided for in the bill, however, foreign profits earned through a subsidiary generally will never be subject to U.S. taxation. Accordingly, new measures to protect against the erosion of the U.S. tax base are warranted.

The deduction allowed for F.D.I.I. and G.I.L.T.I. provides a reduced effective tax rate for G.I.L.T.I. of 10.5%, which is increased to 13.125% after 2025.

This article takes a question and answer approach to examining the new Code §§951A and 250, and revised Code §960. Throughout, new terms are used, new concepts of taxation are applied, and the rules zigzag between looking at C.F.C.'s in the aggregate and looking at each individually.

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[1] See "Impact of the Tax Cuts and Job Act on U.S. Investors in Foreign Corporations" in this edition of *Insights*.

COMPONENTS OF THE G.I.L.T.I. PROVISION

1. What is a C.F.C. and how has the definition been changed?

Under prior and current law, a C.F.C. is any foreign corporation in which U.S. Shareholders (defined below) own more than 50% of the foreign corporation's stock by value or vote.

Under prior law, a foreign corporation was required to be controlled for 30 days before the Subpart F rules applied. Under the new law, the 30-day requirement is no longer in effect.

Under prior law, a U.S. Shareholder was defined as a U.S. person that owned 10% or more of the foreign corporation's voting stock. Under the new law, the definition includes a U.S. person that owns 10% or more of the foreign corporation's stock by value. In addition, the attribution rules for determining constructive ownership of a foreign corporation by a U.S. person are expanded to include attribution from a foreign person to a U.S. person.

2. How does the Subpart F tax regime treat a U.S. Shareholder of a C.F.C. with regard to Subpart F income?

The Subpart F tax regime identifies certain income of a C.F.C. as "tainted" income and requires a U.S. Shareholder of that C.F.C. to automatically include the earnings from that income in its U.S. tax return. When those earnings are distributed in the form of a dividend, the U.S. Shareholder generally treats the dividend as previously taxed income, which is not taxed a second time.

Several forms of tainted income are included in the definition of Subpart F income. Included are items of passive income and mobile income, known as Foreign Personal Holding Company Income ("F.P.H.C.I."). F.P.H.C.I. includes dividends, interest, royalties, and certain gains. From the viewpoint of legislative policy, F.P.H.C.I. can easily be transferred from a company in one country to an affiliated company in another country, pursuant to a search for an acceptably low rate of income tax.

3. How is the traditional policy of Subpart F changed by the G.I.L.T.I. Provision?

In comparison to the traditional approach that looks for specific items of tainted income, the G.I.L.T.I. provision provides a "safe zone" for a portion of the entire pool of C.F.C. earnings. The safe zone is based principally on a hypothetical yield generated by the C.F.C. on its Qualified Business Asset Investment ("Q.B.A.I."), determined on a pre-tax basis. Once the safe zone is computed, all additional earnings of the C.F.C. not otherwise taxed under Subpart F or specifically excepted by the statute are considered to be attributable to G.I.L.T.I.

4. When does the G.I.L.T.I. regime first becomes effective?

For foreign corporations, the G.I.L.T.I. regime is effective for tax years beginning after December 31, 2017. For U.S. Shareholders, the regime is effective for tax years in which or with which the tax year of the foreign corporation ends.

5. **Which U.S. Shareholders of a C.F.C. must include G.I.L.T.I. in taxable income and how much must be included?**

Under Code §951A(a), each person that is a U.S. Shareholder of a C.F.C. for any tax year is the U.S. person that must include in gross income such shareholder's G.I.L.T.I. for such tax year. In Code §951A(e)(3), the statute provides that a foreign corporation is treated as a C.F.C. for any tax year if it is a C.F.C. at any time during such tax year. The statute provides, in Code §951A(e)(2), that a person is treated as a U.S. Shareholder of a C.F.C. for a given tax year only if it owns stock in the foreign corporation on the last day in the tax year of the foreign corporation on which it is a C.F.C. Ownership includes direct ownership and indirect ownership under Code §958(a).

Finally, the statute provides in Code §951A(e)(1) that in determining *pro rata* shares of G.I.L.T.I., including net C.F.C. tested income in Code §951A(b) and Code §951A(c)(1)(A) and (B), the rules of Code §951(a)(2) apply in the same manner as to Subpart F income. Under that provision, Subpart F income is prorated to account for part-year ownership and dividend payments to prior owners, including amounts that are treated as dividends by reason of Code §1248.

These rules, apparently, are designed to provide a straightforward answer, but that answer is not always clear when ownership changes occur.

No Change in Ownership

If ownership does not change during the year, the same U.S. Shareholders that included G.I.L.T.I. in income for the prior year, will do so again. The amount takes into account each U.S. Shareholder's proportional amount of net C.F.C. tested income and the deemed return on Q.B.A.I. *Pro rata* presumably refers to the percentage of ownership interest and rights to dividend flow.

Acquisition of Ownership Interest During the Year

Now, the computation becomes somewhat unclear.

If we assume that all the shares of the target foreign company are purchased from a single seller that is a foreign member of a foreign-based multinational group, it seems that the reference to the *pro rata* rule of Code §951(a)(2) should mean that the computations are prorated to take into account part-year ownership. Thus, the acquirer is a U.S. Shareholder at the end of the year, the foreign corporation is a C.F.C., and G.I.L.T.I. is included on a *pro rata* basis.

On the other hand, if we assume that all the shares of the target foreign company are purchased from a single seller that is a U.S. corporation or that is a foreign member of a U.S.-based multinational group, it seems that the reference to the *pro rata* rule of Code §951(a)(2) contains uncertainty. In principle, the acquisition company is a U.S. Shareholder for only a portion of the year. Hence, G.I.L.T.I. could only be prorated to the tested income and return on Q.B.A.I. for the period of ownership. This would make sense but for the fact that it is not clear that the seller has any G.I.L.T.I. to report for the portion of the year it is a U.S. Shareholder of the C.F.C.: Only U.S. Shareholders on the last day of the year include G.I.L.T.I. and the seller is not a U.S. Shareholder on the last day.

Disposition of Ownership in the Middle of a Year

Comparable issues apply at the time of a disposition of shares of a C.F.C. If there is a disposition transaction that takes place in the middle of a year and all U.S. Shareholders sell their shares to a foreign acquisition company that is a member of a foreign-based multinational group, the U.S. Shareholders of the C.F.C. on the last day in the year on which the foreign corporation is a C.F.C. must include G.I.L.T.I. The statute is clear.

On the other hand, if the purchaser is a member of a U.S.-based group, the status of the foreign corporation as a C.F.C. continues on and the U.S. Shareholder does not have a taxable event under Code §951A(a). From a policy standpoint, a literal application of the statute would place the entire burden on the purchaser, except that it could benefit from the proration rule.

It is unlikely that Congress intended there to be a tax benefit bestowed on the selling party that is not offset by a tax cost on the purchasing party when unrelated U.S. groups are on both sides of a stock purchase transaction. Presumably, this can be addressed in a technical corrections bill.

6. What taxable events are deemed to occur for a U.S. Shareholder when a C.F.C. has G.I.L.T.I.?

Under Code §951A, a U.S. Shareholder of a C.F.C. must include in its gross income its G.I.L.T.I. inclusion in a manner similar to inclusions of Subpart F income. In broad terms, this means that a U.S. Shareholder must include in income the amount of income that would have been distributed with respect to the stock that it owned (within the meaning of Code §958(a)) in the C.F.C. if, on the last day in its tax year on which the corporation is a C.F.C., it had distributed *pro rata* to its shareholders an amount equal to the amount of its G.I.L.T.I.

When a U.S. Shareholder is a corporation, several rules apply in addition to the income inclusion. First, a deemed-paid foreign tax credit is allowed under Code §960 for foreign income taxes allocable to G.I.L.T.I. at the level of the C.F.C. Second, the Code §951A inclusion includes a "gross-up" under Code §78 for the foreign income taxes claimed as a credit. Third, the U.S. corporation is entitled to a 50% deduction (reduced to 37.5% in later tax years) based on the G.I.L.T.I. included in income. As a result, a corporate U.S. Shareholder's effective tax rate on G.I.L.T.I. plus the gross-up will be 10.5% (increased to 13.125% in later tax years).

7. How Is G.I.L.T.I. computed?

G.I.L.T.I. is determined through several computations that appear in Code §951A.

G.I.L.T.I. Defined

With respect to a U.S. Shareholder of a C.F.C., G.I.L.T.I. means the excess of (i) the shareholder's "net C.F.C. tested income" for the shareholder's tax year over (ii) the "net deemed tangible income return." This is expressed in the following formula:

G.I.L.T.I. = Net C.F.C. Tested Income – Net Deemed Tangible Income Return

Where a U.S. Person is a U.S. Shareholder of several C.F.C.'s, G.I.L.T.I. is computed on an aggregate basis that takes into account all its C.F.C.'s. The positive net tested income of each C.F.C. within the group that has positive income is added together to arrive at aggregate positive net tested income. At the same time, the net tested loss of each C.F.C. within the group within the group that has a loss is added together to arrive at aggregate net tested loss. The aggregate positive net tested income is reduced by the aggregate net tested loss to determine G.I.L.T.I.

Net Deemed Tangible Income Return Defined

The U.S. Shareholder's net deemed tangible income return is (i) 10% of the aggregate of the shareholder's *pro rata* share of the Q.B.A.I. (defined below) of each of its C.F.C.'s, reduced by (ii) the interest expense of each C.F.C. that is taken into account in determining the shareholder's net C.F.C. tested income. Here, interest expense means the C.F.C.'s interest expense minus its interest income. This is expressed in the following formula:

$$\textbf{G.I.L.T.I.} = \begin{array}{c}\textbf{Net C.F.C.}\\ \textbf{Tested Income}\end{array} - (\,0.1 \times \textbf{Q.B.A.I.}\,) - \begin{array}{c}\textbf{Net Interest Expense}\\ \textbf{Allocated to}\\ \textbf{Net Tested Income}\end{array}$$

In making the computation, the full amount equal to 10% of Q.B.A.I. cannot be reduced below zero by net interest expense. Stated differently, the net interest expense allocated to 10% of Q.B.A.I. is capped at 10% of Q.B.A.I.

Net C.F.C. Tested Income Defined

Net C.F.C. tested income is the aggregate of (i) the U.S. Shareholder's *pro rata* share of the "tested income," if any, of each of its C.F.C.'s, reduced by (ii) the U.S. Shareholder's *pro rata* share of the "tested loss," if any, of each of its C.F.C.'s. This is expressed in the following formula:

$$\begin{array}{c}\textbf{Net C.F.C.}\\ \textbf{Tested Income}\end{array} = \begin{array}{c}\textbf{Sum of C.F.C.}\\ \textbf{Tested Income}\end{array} - \begin{array}{c}\textbf{Sum of C.F.C.}\\ \textbf{Tested Loss}\end{array}$$

Tested income of a C.F.C. consists of (i) its gross income, excluding certain exceptions, reduced by (ii) its deductions (including taxes) that are properly allocable to such gross income. The exceptions to gross income are as follows:

- An item of income of a C.F.C. from sources within the U.S. that is effectively connected with the conduct of a trade or business within the U.S.
- Gross income of a C.F.C. taken into account in determining Subpart F income
- Gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under Code §954(b)(4) for income subject to an effective rate imposed by a foreign country greater than 90% of the maximum rate of tax specified in Code §11 (which is 21%)
- Dividends received from a related person
- Foreign oil and gas extraction income and foreign oil-related income

The income from sources within the U.S. that is effectively connected with the conduct of a U.S. trade or business must be taxed in the U.S. in order for it to be removed from gross income. Consequently, if the effectively connected income is exempt from U.S. tax or is subject to a reduced U.S. tax rate, it is removed from the list of exceptions to the extent of the benefit. Thus, if a treaty fully exempts the income, the income is fully removed from the exception. On the other hand, if the treaty merely reduces U.S. tax, only a *pro rata* portion of the income is removed from the list of exceptions, based on the percentage by which U.S. tax is reduced.

"Q.B.A.I. means investment in property, plant, and equipment adjusted to reflect depreciation expense using longer lives set forth in Code §168(g)."

Tested loss of a C.F.C. is the excess of (i) deductions (including taxes) properly allocable to the corporation's gross income, not including the tested income exceptions, reduced by (ii) the amount of such gross income.

Q.B.A.I. Defined

Q.B.A.I. means, with respect to a C.F.C., the average of the aggregate of the adjusted bases in specified tangible property used in a trade or business and of a type for which a deduction for depreciation generally would be allowable under Code §167. In terms typically used by corporate management, Q.B.A.I. means investment in property, plant, and equipment adjusted to reflect depreciation expense using longer lives set forth in Code §168(g). Under that provision of U.S. tax law, an alternative depreciation system is applied, *inter alia*, to tangible property used predominantly outside the U.S. The average bases of the assets in the computation is determined by reference to the adjusted bases as of the close of each quarter of the tax year. This reduces the positive and negative effects of asset acquisitions or dispositions during the year.

Specified tangible property means any property used in the production of tested income. Where property is used in part for the production of tested income and in part for the production of excepted income, the adjusted basis must be allocated between the two in the same proportion that the tested income bears to the total gross income arising from the use of the property.

If a C.F.C. holds an interest in a partnership, the C.F.C.'s distributive share of the aggregate of the partnership's adjusted bases in its assets must be taken into account for purposes of computing the Q.B.A.I. for the year.

8. When a U.S. person is a U.S. Shareholder of several C.F.C.'s, how is the G.I.L.T.I. amount included in the U.S. Shareholder's income allocated among C.F.C.'s?

When a U.S. person is a U.S. Shareholder of several C.F.C.'s, the amount of G.I.L.T.I. included in the income of the U.S. Shareholder is allocated on a *pro rata* basis among the C.F.C.'s having positive tested income. None of the G.I.L.T.I. is allocated to a C.F.C. that has negative tested income. The allocation method is expressed in the following formula with regard to each C.F.C. having positive net C.F.C. tested income:

$$\text{Portion of G.I.L.T.I. Allocated to C.F.C.} = \text{U.S. Shareholder's G.I.L.T.I.} \times \frac{\text{C.F.C. Tested Income Allocated to U.S. Shareholder}}{\text{Aggregate Tested Income of All C.F.C.'s of U.S. Shareholder}}$$

The allocation affects the computation of the deemed-paid foreign tax credit and the Code §78 gross up computation for each C.F.C. within the group.

9. **<u>Does a G.I.L.T.I. inclusion constitute Subpart F income of a U.S. Shareholder?</u>**

No. The G.I.L.T.I. inclusion by a U.S. Shareholder does not constitute an inclusion of Subpart F income. Nonetheless, G.I.L.T.I. inclusions are generally treated in a manner that is similar to Subpart F inclusions for purposes of applying Code §§168(h)(2)(B), 535(b)(10), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4). Among other things, this means that a U.S. Shareholder that is an individual should be allowed to compute the tax on an inclusion of G.I.L.T.I. under Code §962 as if the individual were a U.S. corporation with respect to the G.I.L.T.I. This would reduce the tax imposed on G.I.L.T.I. by the amount of the deduction allowed under Code §250. Dividends actually received by such U.S. Shareholder would then be taxed as qualified dividends paid by a U.S. domestic corporation, even if the C.F.C. distributing an actual dividend is based in a jurisdiction that does not have an income tax treaty in effect with the U.S. In addition, the previously taxed income rules under Code §959(a)(1)(A) would ensures that Subpart F should not apply to dividends that flow up a chain of C.F.C.'s., other than in limited circumstances.

10. **<u>Can a U.S. corporation claim an indirect foreign tax credit for taxes properly allocable to tested income of a C.F.C.?</u>**

Yes, a foreign tax credit is provided, but it is subject to relatively strict terms and conditions that are not typically found in the foreign tax credit provisions under U.S. law.

<u>Foreign Tax Credit Allowed</u>

For G.I.L.T.I. that is included in the gross income of a domestic corporation (including, for this purpose, an individual who elects to be taxed as a corporation), a "deemed-paid" foreign tax credit will be allowed. The credit equals 80% of the product of the corporation's "inclusion percentage" multiplied by the "aggregate tested foreign income taxes" paid or accrued by C.F.C.'s. This is expressed in the following formula:

"The 80% cap on creditable foreign income taxes applicable to G.I.L.T.I. affects the overall combined rate of foreign and U.S. income tax."

$$\textbf{Deemed-Paid Foreign Tax Credit} = (\,0.8 \times \textbf{Inclusion Percentage}\,) \times \textbf{Aggregate Tested Foreign Income Taxes}$$

For computational reasons, the 80% cap on creditable foreign income taxes applicable to G.I.L.T.I affects the overall combined rate of foreign and U.S. income tax. This is discussed below.

<u>Inclusion Percentage and Tested Foreign Income Taxes Defined</u>

The inclusion percentage of a domestic corporation is determined by dividing (i) the corporate U.S. Shareholder's total G.I.L.T.I. (aggregate tested income of each C.F.C. in excess of 10% of all C.F.C.s' Q.B.A.I. and net interest expense) by (ii) the aggregate amount of its *pro rata* share of the tested income for each C.F.C. of which it is a U.S. Shareholder. As discussed above, tested income means gross income, reduced by income that is excepted, and reduced further by deductions properly allocable to the gross income.

Tested foreign income taxes of a C.F.C. means foreign income taxes paid or accrued by the C.F.C. that are attributable to tested income. Tested foreign income taxes do not include any foreign income tax paid or accrued by a C.F.C. that is properly attributable to the C.F.C.'s tested loss.

Deemed-Paid Foreign Tax Credit and Gross-up

The deemed-paid foreign tax credit is similar to the indirect foreign tax credit under the now-repealed Code §902, except the deemed-paid credit is limited to 80% of the foreign taxes paid. The foreign taxes deemed to have been paid increase G.I.L.T.I. in the same manner as the Code §78 gross-up. Consequently, the amount grossed up is equal to the entire amount of the inclusion percentage and aggregate tested foreign income taxes, even though only 80% are used when computing the deemed-paid credit. The Code §78 gross-up can be expressed in the following formula with regard to each C.F.C. having positive net C.F.C. tested income:

$$\textbf{Code §78 Gross-up} = \frac{\textbf{G.I.L.T.I.}}{\textbf{Aggregate Tested Income}} \times \textbf{Aggregate Tested Foreign Income Taxes}$$

The provision creates a separate foreign tax credit basket for G.I.L.T.I., with no carryforward or carryback available for excess credits. For purposes of determining the foreign tax credit limitation, G.I.L.T.I. is not general category income, and income that is both G.I.L.T.I. and passive category income is considered passive category income.

Illustration 1

To illustrate how the computation works, assume that Corp. A is a domestic corporation that is the sole shareholder of C.F.C. X., its only C.F.C. Corp. A has a manufacturing plant in the country in which C.F.C. X is located.

The Form 5471 prepared by Corp. A with regard to C.F.C. X reports the following:

•	Gross income from:	
○	Foreign base company sales operations	$100X
○	In-country sales operations	50X
○	Investment income	10X
○	Total gross income	$160X
•	Operating expenses related to:	
○	Foreign base company sales operations	$30X
○	In country sales operations	8X
○	Investment income	0X
○	Total expenses	$38X
•	G&A expenses	$5x
•	Net income before tax	$117X
•	Foreign income tax @25% (rounded down)	$29X
•	Net earnings after foreign income tax	$88X

Assume further that the average adjusted basis in the property, plant, and equipment ("P.P.&E.") of C.F.C. X is $250 and C.F.C. X does not have interest expense.

The relevant computations are as follows:

- The tested gross income of C.F.C. X is $50X, comprised of its total gross income of $160X, reduced by excepted income of $110X attributable to its two items of Subpart F gross income (*i.e.*, foreign base company sales gross income of $100X and foreign personal holding company gross income of $10X).
- The operating expenses of C.F.C. X attributable to in-country sales are $8X and the G&A expenses allocated to the in-country sales, computed using an apportionment ratio based on the ratio of in-country sales to total operating gross income (*i.e.*, 50X ÷ 150X = 0.33), are $2X rounded up. Investment income has no operating or G&A expenses allocated to it. Foreign income tax is apportioned based on the relationship of (i) net tested income before tax for in-country sales ($40) to (ii) total net income before tax and is $10X rounded up (*i.e.*, 40X ÷ 117X x 29X).
- As a result, the net tested loss (*i.e.*, deductions, including taxes) allocated to the tested income of $50X is $20X (*i.e.*, $8X + $2X + $10X).
- 10% of Q.B.A.I. is $25X (*i.e.*, 250X x 0.1).
- C.F.C. X's net tested income is tested income ($50X) minus tested loss ($20X) and is $30X.
- Corp. A's G.I.L.T.I. inclusion is net tested income ($30X) in excess of 10% of C.F.C. X's Q.B.A.I. ($25X) and is $5X.
- The inclusion percentage for the purpose of computing the deemed-paid credit is 10%.
- Corp. A's foreign tax credit before the 80% cap on the deemed-paid credit is $1X (*i.e.*, 0.1 x $10X).
- Corp. A's foreign tax credit after the 80% cap is $0.80X (*i.e.*, $1X x 0.8).
- The foreign tax credit is placed in a separate limitation pool and any excess credit for the year is lost.

<u>Illustration 2</u>

Assume that Corp. B is a domestic corporation that is the sole shareholder of C.F.C. Y, its only C.F.C. Both Corp. B and C.F.C. Y are software engineering companies that use independent contractors based in Eastern Europe. Non-U.S. customers are serviced by C.F.C. Y. For the purpose of this example, C.F.C. Y does not have any foreign base company sales or services income that might be taxed under Subpart F or investment income.

The Form 5471 prepared by Corp. B with regard to C.F.C. Y reports the following:

• Gross income from:	
○ Non-U.S. customers	$50X
○ Total gross income	$50X
• Operating expenses related to:	
○ Gross income from non-U.S. customers	$4X
○ Total expenses	$4X
• G&A expenses	$1x
• Net income before tax	$45X
• Foreign income tax @25% (rounded down)	$11X
• Net earnings after foreign income tax	$34X

Since C.F.C. Y uses independent contractors, it does not have P.P.&E. Further, we assume that C.F.C. Y does not have interest expense.

The relevant computations are as follows:

- The tested gross income of C.F.C. Y is $50X.
- The operating expenses of C.F.C. Y for in-country sales are $4X, the G&A expenses are $1X, and the foreign income tax is $11X.
- The deductions, including taxes, allocated to the tested income of $50X is $16X (*i.e.*, $4X + $1X + $11X).
- Q.B.A.I. is zero because C.F.C. Y does not have specified tangible property.
- C.F.C. Y's net tested income is tested income ($50X) minus deductions ($16X) and is $34X.
- Corp. B's G.I.L.T.I. inclusion is net tested income ($34X) in excess of 10% of C.F.C. Y's Q.B.A.I. ($0) and is $34X.
- The inclusion percentage for the purpose of computing the deemed-paid credit is 68%.
- Corp. B's foreign tax credit before the 80% cap on the deemed-paid credit is $8X rounded up (*i.e.*, 0.68 x $11X).
- Corp. B's foreign tax credit after the 80% cap is $6X rounded down (*i.e.*, $8X x 0.8).

In each illustration, once the amount of the G.I.L.T.I. inclusion is determined for the domestic corporation, it is entitled to a statutory deduction that reduces the tax rate to an attractive percentage. This is discussed below in conjunction with a comparable deduction for F.D.I.I.

The above illustrations show that U.S. Shareholders whose businesses are not P.P.&E.-intensive will be more severely impacted by the G.I.L.T.I. regime. Further, Illustration 1 demonstrates that the G.I.L.T.I. regime does not incentivize U.S. businesses to manufacture in the U.S.

COMPONENTS OF THE F.D.I.I. PROVISION

11. What is F.D.I.I.?

F.D.I.I. is the portion of a U.S. corporation's intangible income derived from serving foreign markets, determined by a formula. The F.D.I.I. of any U.S. corporation is the amount that bears the same ratio to the "deemed intangible income" of the corporation as (i) the "foreign-derived deduction eligible income" of the corporation bears to (ii) the "deduction eligible income" of the corporation. The F.D.I.I. formula may be expressed as follows:

$$\text{F.D.I.I.} = \text{Deemed Intangible Income} \times \text{Foreign-Derived Deduction Eligible Income} \div \text{Deduction Eligible Income}$$

> *"The deduction for F.D.I.I. is a deduction of a U.S. corporation, and does not depend on whether the U.S. corporation's foreign income is earned through a C.F.C."*

Three new terms must be defined to properly apply the formula: (i) deemed intangible income, (ii) deduction eligible income, and (iii) foreign-derived deduction eligible income. The concepts are not very different from those discussed above for G.I.L.T.I., except that they are applied in a domestic context and the computations are designed from the basis of a deduction for a U.S. corporation rather than an amount of otherwise deferrable earnings of a C.F.C. that must be included in U.S. income. Stated differently, it is important to note that the deduction for F.D.I.I. is a deduction of a U.S. corporation, and does not depend on whether the U.S. corporation's foreign income is earned through a C.F.C.

Deemed Intangible Income

Deemed intangible income of a U.S. corporation is the excess of its (i) deduction eligible income over (ii) deemed tangible income return. The deemed tangible income return is, with respect to any corporation, an amount equal to 10% of the domestic corporation's Q.B.A.I, except that the term "deduction eligible income" is substituted for "tested income" and without regard to whether the corporation is a C.F.C. This may be expressed in the following formula:

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - (\,0.1 \times \text{Q.B.A.I.}\,)$$

Q.B.A.I.

A domestic corporation's Q.B.A.I. is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the tax year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is allowable under Code §167. The adjusted basis in any property must be determined using the alternative depreciation system under Code §168(g), notwithstanding any provision of law enacted after this provision. Use of this depreciation method increases the basis in Q.B.A.I. at any point in time because the useful lives of assets are greater than the useful lives used when depreciation is computed under Code §167.

Specified tangible property means any tangible property used in the production of deduction eligible income. If such property is dual-use property that is used in the production of deduction eligible income and other income, the property is treated as specified tangible property in the same proportion that the deduction eligible gross income produced with respect to the property bears to the total gross income produced with respect to the property. This may be expressed in the following formula:

$$\text{Q.B.A.I. from Dual-Use Property} = \text{Average Adjusted Bases in Specified Tangible Property} \times \text{Deduction Eligible Gross Income Produced with Respect to the Property} \div \text{Total Gross Income Produced with Respect to the Property}$$

The demand for cost segregation studies by U.S. companies manufacturing for export is expected to be quite high, as assets must be matched with revenues derived by the U.S. corporation. It is not likely that the required tracking can be achieved without a cost segregation study.

Deduction Eligible Income

Deduction eligible income is, with respect to any U.S. corporation, the excess of (i) gross income of the corporation, excluding specified exceptions, over (ii) allocable deductions (including taxes). It may be expressed in the following formula:

$$\text{Deduction Eligible Income} = \text{Gross income} - \text{Exceptions} - \text{Allocable Deductions}$$

Exceptions to Gross Income

The exceptions from the U.S. corporation's gross income when computing F.D.I.I. are as follows:

- Subpart F income
- G.I.L.T.I.
- Certain financial services income, as defined in Code §904(d)(2)(D), relating to the active conduct of a banking, insurance, financing, or similar business
- Any dividend received from a C.F.C. with respect to which the U.S. corporation is a U.S. Shareholder
- Certain domestic oil and gas extraction income
- Any foreign branch income as defined in Code §904(d)(2)(J)

Foreign-Derived Deduction Eligible Income

Foreign-derived deduction eligible income is, with respect to any taxpayer for its tax year, any deduction eligible income (*i.e.*, gross income, reduced by exceptions and allocable deductions) derived in connection with (i) property that is sold by the taxpayer to any person who is not a U.S. person and that is established to be for foreign use or (ii) services provided by the taxpayer that are established to be provided to any person not located in the U.S. or with respect to property not located in the U.S.

The I.R.S. is given broad discretion in determining whether the taxpayer has met its burden of proof in establishing that property has been sold for use outside the U.S. or services have been performed for persons or with regard to property located outside the U.S. The terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition. Foreign use means any use, consumption, or disposition outside the U.S.

Property sold to another person (other than a related party, as discussed below) for further manufacture or other modification in the U.S. is not treated as sold for a foreign use, even if the other person subsequently uses the property for foreign use. Similarly, services provided to another person (other than a related party, as discussed below) located in the U.S. do not generate foreign-derived deduction eligible income even if that other person uses the services in providing services generating foreign-derived deduction eligible income for itself.

If property is sold to a foreign related party, the sale is not treated as for a foreign use, unless the property is ultimately sold by the foreign related party to another person who is unrelated and foreign, and the taxpayer establishes to the satisfaction of the I.R.S. that the property is for foreign use. Similarly, if a service is provided to a related party who is not located in the U.S., the service is not treated as provided for persons or with regard to property located outside the U.S., unless the taxpayer establishes to the satisfaction the I.R.S. that the service is not substantially similar to services provided by the related party to persons located in the U.S.

For this purpose, a related party means any member of an affiliated group of corporations within the meaning of Code §1504(a), with certain adjustments. The adjustments are that a 50%-ownership standard is used, instead of the 80% standard under of Code §1504(a), and insurance companies and foreign corporations are not excluded. In addition, business entities other than corporations can be treated as persons related to a corporation within a group if they are controlled by, or control, a second corporation that is a related person to the first. For this purpose, Code §954(d)(3) concepts of control apply. As a result, ownership, directly or indirectly, of more than 50% (by value) of the beneficial interests in a business entity such as a partnership, trust, or estate could cause that entity to be controlled by a related corporation.

Deemed Intangible Income

A domestic corporation's deemed intangible income means the excess (if any) of its deduction eligible income over its deemed tangible income return. The deemed tangible income return means, with respect to any corporation, an amount equal to 10% of the corporation's F.D.I.I. Q.B.A.I.

In broad terms, F.D.I.I. Q.B.A.I. is computed in a manner that is similar to Q.B.A.I., but with a focus on assets used in the production of deduction eligible income. Again, an asset segregation study will be required to demonstrate classes of income related to the use of the property. If property is dual-use property, the portion that is considered F.D.I.I. Q.B.A.I. is based on the relationship between deduction eligible gross income and total gross income produced with respect to the property. Deemed intangible income can be calculated as follows:

$$\text{Deemed Intangible Income} = \text{Deduction Eligible Income} - (0.1 \times \text{Q.B.A.I.})$$

The deemed intangible income is eligible for the deduction described below.

Illustration 3

To illustrate how the computation works, assume that Corp. C is a corporation that is tax resident in a member country of the European Union. Corp. C is engaged in the dairy business. Its global sales are expanding, and for that reason, its U.S. subsidiary, Corp. D, is tasked to build a cheese production plant in the U.S. The output of the plant is sold to unrelated distributors in the U.S. and other places. For the tax year in issue, domestic sales make up 50% of the sales volume and foreign sales make up the balance.

In this example

- intercompany license fees for use of knowhow are ignored,
- state and local taxes are ignored,
- there are no exceptions to gross income for purposes of computing F.D.I.I.,
- the cheese sold for export is identical in all respects to the cheese sold in-country, and
- the price per unit sold is the same for export sales and in-country sales.

The Form 1120 prepared by Corp. D reports the following:

• Gross income from:	
○ Export sales of domestically produced cheese	$100X
○ In-country sales of domestically produced cheese	100X
○ Total gross income	$200X
• Operating expenses related to:	
○ Export sales of domestically produced cheese	$30X
○ In-country sales of domestically produced cheese	30X
○ Total expenses	$60X
• G&A expenses	$12x
• Income before tax	$128X

Assume further that the average adjusted basis in P.P.&E. at the cheese production plant is $90X.

The relevant computations are as follows, possibly subject to modification when final regulations are issued by the I.R.S.:

- The deduction eligible income of Corp. D is $128X (*i.e.*, gross income ($200X) – exceptions ($0) – allocable deductions ($72X)).

- The foreign-derived deduction eligible income is $64 (*i.e.*, deduction eligible income derived in connection with property that is sold to any person (here unrelated) who is not a U.S. person for use outside the U.S.).
- The Q.B.A.I. is $90X, and 10% of Q.B.A.I. is $9X.
- The deemed intangible income is $119X (*i.e.*, the excess of foreign-derived deduction eligible income ($128X) over 10% of Q.B.A.I. ($9X)).
- The F.D.I.I. is $59.5X (*i.e.*, deemed intangible income multiplied by the percentage of the deduction eligible income that is foreign-derived (50%)).

Once the amount of the F.D.I.I. is determined for Corp. D, it is entitled to a statutory deduction that reduces the tax rate to an attractive percentage. This statutory deduction is discussed below in conjunction with a comparable deduction for G.I.L.T.I.

Corp. D's U.S. Federal income tax is the sum of the regular tax of 21% on $64X of income from domestic sales plus the reduced tax on foreign derived deduction eligible income, or $13.44X plus the amount $7.81X, which is $21.25X in the aggregate. On these facts, the effective rate of U.S. Federal income tax on total taxable income is 16.6%.

<u>*Illustration 4*</u>

Assume that Corp. E is a domestic corporation that is engaged in the business of providing software engineering solutions for customers. Corp. E's customers are in the U.S. and Europe. Corp. E's only office is in the U.S. When it is retained to perform projects, it regularly relies on independent contractors to work on those projects. These contractors may be based inside or outside the U.S. They provide services to many different customers, and their location does not affect the choice of jobs they receive.

In this example, it is assumed that none of the independent contractors (i) is classified as an employee under standards used in the U.S. and abroad, or (ii) constitutes a branch in the country where the individual is located. Corp. E has no P.P.&E. reported on its tax balance sheet.

Further, in this example

- state and local taxes are ignored, and
- there are no exceptions to gross income for purposes of computing F.D.I.I.

The Form 1120 prepared by Corp. E reports the following:

• Gross income from:	
○ Service fees derived from customers abroad	$100X
○ Service fees derived from customers in the U.S.	100X
○ Total gross income	$200X
• Operating expenses related to:	
○ Projects for foreign customers	$30X
○ Projects for U.S. customers	30X

○	Total operating expenses	$60X
•	G&A expenses	$12x
•	Income before tax	$128X

The relevant computations are as follows, possibly subject to modification when final regulations are issued by the I.R.S.:

- The deduction eligible income of Corp. E is $128X (*i.e.*, gross income ($200X) – exceptions ($0) – allocable deductions ($72X)).
- The foreign-derived deduction eligible income is $64X (*i.e.*, deduction eligible income derived in connection with property that is sold to any person (here unrelated) who is not a U.S. person for use outside the U.S.).
- The Q.B.A.I. is $0.
- The deemed intangible income is $128X (*i.e.*, the excess of deduction eligible income ($128X) over Q.B.A.I. ($0)).
- The F.D.I.I. is $64X (deemed intangible income multiplied by the percentage of the deduction eligible income that is foreign-derived (50%)).

Once the amount of the F.D.I.I. is determined for Corp. E, it is entitled to a statutory deduction that reduces the tax rate to an attractive percentage. This statutory deduction is discussed below in conjunction with a comparable deduction for G.I.L.T.I.

Corp. E's U.S. Federal income tax is the sum of the regular tax of 21% on $64X of income from domestic sales plus the reduced tax on foreign derived deduction eligible income, or $13.44 plus the amount $8.4X, which is $21.88X in the aggregate. On these facts, the effective rate of U.S. Federal income tax on total taxable income is 17.06%.

COMPONENTS OF THE DEDUCTION SYSTEM FOR G.I.L.T.I. AND F.D.I.I. DERIVED BY CORPORATIONS

12. <u>How do the statutory deductions work when a corporation includes G.I.L.T.I. in income or can demonstrate that it has F.D.I.I.?</u>

Code §250 provides that a U.S. corporation is allowed notional deductions when computing taxable income under the F.D.I.I. and G.I.L.T.I provisions of U.S. tax law. The intent is to create a target amount of tax that is substantially less than the 21% corporate tax rate.

Thus, for a taxable year beginning after 2017 and before 2026, a U.S. domestic corporation may deduct (i) 37.5% of its F.D.I.I. and (ii) 50% of its G.I.L.T.I. In light of the 21% corporate income tax, the effective U.S. tax rates are 13.125% on F.D.I.I. and 10.5% on G.I.L.T.I. The effective rate of tax on F.D.I.I. is described above in the illustration of the F.D.I.I. computation.

For tax years beginning after December 31, 2025, the deduction is reduced to (i) 21.875% of F.D.I.I. and 37.5% of G.I.L.T.I. Assuming the 21% corporate income tax remains, the post-2025 effective U.S. rates are 16.406% on F.D.I.I. and 13.125% on G.I.L.T.I.

The amount of the deduction is capped by the domestic corporation's taxable income for the year. Consequently, if, in any tax year, a U.S. corporation's F.D.I.I. and G.I.L.T.I. amounts exceed its taxable income, the deduction is reduced so that it cannot produce a loss.

13. Regarding G.I.L.T.I., how is the overall effective rate of foreign and U.S. taxes affected by the 80% cap on creditable foreign income taxes?

In many instances, the combination of a 21% corporate tax rate, a deduction of 50% of the G.I.L.T.I., and the deemed-paid credit capped at 80% of creditable foreign income taxes increases the combined effective rate of foreign and U.S. income tax to 13.125% or more, depending on the tax rate abroad. Because only 80% of foreign tax credits are allowed to offset U.S. tax on G.I.L.T.I., the minimum foreign effective tax rate at which no U.S. residual tax is owed by a domestic corporation with respect to G.I.L.T.I. must be increased so that 80% of the foreign rate equals 10.5%. Thus, the U.S. tax is completely eliminated without mathematical slippage when the foreign tax rate 13.125%, as determined by the following formula:

"For domestic corporations in taxable years beginning after 2025, . . . the minimum foreign tax rate, with respect to G.I.L.T.I., at which no U.S. residual tax is owed is 16.4%."

$$10.5\% \div 80\% = 13.125\%$$

If the effective foreign income tax rate on G.I.L.T.I. is zero, the U.S. residual tax rate on G.I.L.T.I is 10.5%. As effective foreign income tax rates on G.I.L.T.I. increase from 0% to 13.125%, the total combined foreign and U.S. tax rate on G.I.L.T.I. ranges between 10.5% and 13.125%. If the foreign tax exceeds 13.125%, the credits cannot be used as there is no carryforward of unused foreign tax credits in connection with a G.I.L.T.I. inclusion.

For domestic corporations in taxable years beginning after 2025, the effective tax rate on F.D.I.I. is 16.406% and the effective U.S. tax rate on G.I.L.T.I. is 13.125%. Using the same formula as above, but adjusting the rate of tax, the minimum foreign tax rate, with respect to G.I.L.T.I., at which no U.S. residual tax is owed is 16.4%.

As discussed above, the G.I.L.T.I. computation is not taxpayer friendly. Only 80% of the foreign income taxes allocable to G.I.L.T.I. can reduce the U.S. tax on G.I.L.T.I. As a result, foreign taxes offset U.S. taxes in the ratio of 1.25 foreign tax credits to 1.00 U.S. taxes. In addition, because G.I.L.T.I. is a theoretical concept that simply applies to a percentage of income in excess of a base amount and is placed in a separate foreign tax credit limitation basket, it will likely not be unusual for foreign taxes imposed at rates in excess of 10.5% to be sucked into the G.I.L.T.I. basket. To the extent that foreign tax is imposed on G.I.L.T.I. at a rate in excess of 13.125%, no benefit will be obtained from the foreign tax credit in the G.I.L.T.I. limitation basket. More importantly, such unused foreign tax credits cannot be carried forward or back and are removed from the general limitation basket. Such unused credits are lost, absolutely.

14. When is the deduction for F.D.I.I. and G.I.L.T.I. first effective?

The deduction for F.D.I.I. and G.I.L.T.I. is effective for tax years beginning after December 31, 2017.

INITIAL PLANNING OPPORTUNITIES

Initial planning opportunities that have been discussed in presentations in the period since the G.I.L.T.I. provisions were first announced include the following:

- Increase Q.B.A.I. to lower G.I.L.T.I. Remember that G.I.L.T.I. is defined as the excess of (i) the U.S. Shareholder's net C.F.C. tested income for the shareholder's tax year over (ii) the C.F.C. net deemed tangible income return. If tangible assets are increased, the return on tangible assets is increased. Whether this alternative is appropriate for a U.S. corporation will depend on the tax rate overseas and the size of the investment constituting Q.B.A.I. Presumably, it will work best for Q.B.A.I. located in no-tax or low-tax jurisdictions that cannot use the foreign tax credit to reduce the tax on the G.I.L.T.I.
- Elect Code §338 treatment when entering a stock purchase agreement regarding a foreign target corporation. Code §338 allows an acquiring corporation to treat stock sales as asset sales. In this way, the election can trigger an increase Q.B.A.I. and a reduction in the G.I.L.T.I. inclusion. The same would be true for a "check-the-box" election that is made effective as of the date of a stock purchase.
- Where a U.S. Shareholder of a C.F.C. is an individual, a Code §962 election may be appropriate. Under this election, the individual's tax on G.I.L.T.I. would be computed as if the C.F.C. were held by a corporation. While G.I.L.T.I. does not give rise to Subpart F income, it is treated in the same way as Subpart F income for various Code provisions, including Code §962.
- Where a U.S. Shareholder of C.F.C. is an individual who does not wish to make an election under Code §962, formation of a U.S. holding company might be appropriate, subject to tax issues that may arise under the personal holding company tax and accumulated earnings tax provisions of U.S. tax law. Those concerns suggest that the choice of making an election under Code §962 is preferable.
- Some state and local taxing jurisdictions may exclude Subpart F income from the state and local tax base. If the exclusion is not extended to the G.I.L.T.I. inclusion, taxpayers may be subject to state and local taxes on G.I.L.T.I. Taxpayers may consider doing business in states that address the different treatment of Subpart F and G.I.L.T.I., or states in which G.I.L.T.I. will otherwise not be included in the tax base.

CONCLUSION

The enactment of the 2017 Tax Cuts and Jobs Act, U.S. tax law for international operations has introduced changes that are as far reaching as the introduction of Subpart F in 1962. It apparently did so in a matter of two months. Nonetheless, its effect on tax planning will likely touch every U.S.-based corporation participating in global operations. The G.I.L.T.I. income inclusion for all and the corporate deductions for G.I.L.T.I. and F.D.I.I. are two important parts of the Act. This article is a first step in understanding how the new rules work. Prompt final guidance from the I.R.S. on the methodology that will be applied in computing the G.I.L.T.I. inclusion and the related foreign tax credit will be helpful.