Analysis

US tax reform: the GILTI and FDII provisions

Speed read

December's US tax reform introduced many new concepts, two of which were the new areas of global intangible low taxed income (GILTI) and foreign derived intangible income (FDII). GILTI allows controlled foreign companies of US companies to earn a return on their hard assets, with any excess being potentially subject to US tax, subject to certain deductions and provisions. FDII effectively mirrors these provisions, by introducing a new regime for taxing income earned in the US in respect of intangibles for certain foreign activities. It is recommended that UK professionals advising businesses with large US operations devote time to understanding the rules and work with affected businesses to analyse their impact.

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US tax reform fundamentally reshaped the way in which the US taxes numerous areas. In our previous article ('US tax reform: practical aspects', *Tax Journal*, 15 June 2018), we wrote about the impact of three of the major changes that were introduced: the new base erosion and anti-abuse tax (BEAT); the enhanced interest deductibility restrictions; and the introduction of hybrid rules.

We did not examine the new global intangible low taxed income (GILTI) provisions, as their scale requires a detailed discussion. We are therefore devoting this article to GILTI, together with the closely-related provisions on foreign derived intangible income (FDII).

This article will be relevant both to US companies with UK operations and to UK companies with US operations.

The previous regime

Practitioners working in this field will be familiar with the Subpart F rules, the US's equivalent of the UK's controlled foreign company (CFC) rules. However, Subpart F principally targets certain flows of passive income between CFCs, and therefore many CFCs have earned income in the past that has not been subject to Subpart F.

Prior to tax reform, distributions from CFCs to the US were generally taxable on repatriation; therefore, all income earned by CFCs would ultimately be taxable in the US, with the potential for a credit for foreign taxes. However, unless Subpart F applied no US tax would arise *until the point of repatriation*. This was termed 'deferral'.

The introduction of GILTI effectively ends deferral on the majority of a CFC's foreign earnings.

Historically, US companies tended to be structured such that their foreign taxes were organised into high tax and low tax pools, with the intent of using foreign tax credits (FTCs) efficiently. With the US's new dividend exemption, one might think this will be unnecessary in the future; however, the mechanism by which GILTI allows FTCs to be utilised likely means that managing tax pools will continue, albeit with a different focus.

GILTI overview

GILTI stems from a problem faced by framers of US tax policy: where a subsidiary of a US company is resident in a low tax jurisdiction, should the US tax the profits arising there? In particular, where a company is making a large return, is it reasonable to suppose that a reason for its location is US tax planning, rather than business need?

Of course, many businesses need to operate in certain countries regardless of the tax rate. As an example, a company in the hotel sector with a business in Bermuda is there not because of its tax rate, but because it is impossible to operate a hotel in Bermuda by locating that hotel in New York.

> GILTI seeks to solve the problem [of whether the US should tax the profits of a US company's subsidiary which is resident in a low tax jurisdiction] by subjecting certain profits to US tax, after permitting companies to earn an acceptable return on particular tangible assets, and with a method for crediting taxes

GILTI therefore seeks to solve the problem by subjecting certain profits to US tax, after permitting companies to earn an acceptable return on particular tangible assets, and with a method for crediting taxes. The mechanism to achieve this is outlined below.

Where GILTI applies, the profits are effectively taxed at a reduced rate, compared to the overall federal corporate tax rate of 21%. The rules took effect for tax years of CFCs beginning after 31 December 2017, and therefore CFCs with a calendar year end will see the rules apply for the year ending 31 December 2018.

Conceptually, it is important to view the GILTI provisions together with other changes introduced by US tax reform, notably the dividend exemption: whilst it would be easy to characterise the dividend exemption as creating a territorial system, the existence of GILTI actually means that the US has become a quasi-full inclusion system, after a small allowance for a return on tangible assets and a further deduction mechanism.

The meaning of 'intangible'

When considering whether GILTI could apply, it might seem logical in some cases to assume it away. For example, many businesses that started in the US and developed foreign operations later would never have consciously transferred any intangibles outside the US. They may therefore consider that GILTI cannot apply to them, since their intangible income must arise in the US. However, this would be incorrect, since GILTI takes a very broad view of what represents intangible income.

In particular, GILTI allows companies a return of 10% on their tangible assets, with any return above that level being *deemed* to represent intangible income. Therefore, the fact that a US company's CFCs may have no identifiable intangibles is irrelevant to whether GILTI affects them.

The mechanics of GILTI

GILTI acts in a similar way to Subpart F income, by creating a deemed income inclusion at the level of the US shareholder of certain profits of its CFCs, despite the fact that they have not been distributed.

GILTI takes the excess of all of the CFCs' aggregate 'net CFC tested income' over their 'net deemed tangible income return' (NDTIR), reduced on a proportionate basis where the US shareholder owns less than 100% of a CFC.

These terms require definition:

- 'Net CFC tested income' is calculated as the US shareholder's pro rata share of the 'tested income' of each of its CFCs, less the US shareholder's pro rata share of any 'tested losses' of its CFCs.
- 'Tested income' means all of a CFC's gross income (reduced by certain exclusions including deductible expenses, Subpart F income, dividends from related companies and income that is effectively connected to a US trade or business), minus certain deductions such as interest expense and taxes.
- A 'tested loss' arises where those deductions exceed gross income.
- A US shareholder's NDTIR is 10% of its CFCs' qualified business asset investment (QBAI), minus certain interest expense.
- QBAI refers to the US tax basis in a CFC's tangible depreciable property. As a result, QBAI will generally include plant and machinery but not real property. We expect there to be substantial differences between how GILTI affects different industries. A company operating in the manufacturing sector would expect QBAI to be relatively significant (since it likely uses valuable machinery and equipment), whereas a financial services business would expect low QBAI, since such businesses likely have relatively little in the way of tangible depreciable assets.

Once GILTI has been determined, it is necessary to consider the impact of FTCs. Where foreign taxes are paid or accrued in respect of tested income, GILTI will allow a credit for these taxes, but only at 80% of the taxes paid or accrued. However, the foreign taxes are also treated as additional income of the US shareholder, without the 20% haircut. This is termed the 'section 78 gross-up'.

The 50% deduction

If the calculation stopped there, it is likely the US would be levying tax at or near their standard 21% corporate tax rate. However, s 250 of the US Tax Code allows a US corporation to take a deduction against overall taxable income. This deduction is calculated as 50% of the GILTI plus the s 78 gross-up. This deduction is, however, capped by the level of the US shareholder's taxable income, and therefore in practice the deduction may be less than 50% of the GILTI (and may be zero, in the event that the US shareholder has no taxable income).

However, where the s 250 deduction applies in full, one would expect the effective tax rate on GILTI to be 10.5%.

The 50% deduction is available until the end of 2025, when it is scheduled – absent further action by Congress – to drop to 37.5% from 2026 onwards. From that point, the effective tax rate on GILTI rises to 13.125%.

Foreign tax credits

The US shareholder can take credit for taxes paid overseas, where those taxes relate to the same income. However, as noted above, only 80% of the foreign taxes can be credited and therefore paying an effective rate overseas of 10.5% will be insufficient to ensure that no tax is payable on the GILTI. Instead, a US shareholder would need to suffer foreign taxes of at least 13.125%, in order for no tax to arise (or 16.406% from 2026 onwards), and in practice the taxes may well need to be higher due to the expense allocation mechanism.

This mechanism exists because FTCs associated with GILTI income are only available to offset the US federal income taxes that would arise on net foreign source GILTI income. Some expenses incurred at the US parent level, such as head office costs and interest expense, must be allocated to the various types of foreign sourced income. Current regulations on how this expense allocation is performed predate the GILTI rules. As such, it is not entirely clear how this should be performed in the context of GILTI, and it is expected that new regulations will be issued. It is likely that some portion of the allocable costs will be allocated to GILTI, which would reduce the amount of tax on the GILTI against which a credit can be taken.

One might expect the treatment of FTCs in respect of GILTI to follow that of most other FTCs. However, FTCs in respect of GILTI are highly inflexible, with the result that they cannot be carried forward, carried back or surrendered to other US shareholders in the group.

As a result, a US shareholder with CFCs suffering an effective tax rate of 20% in one year and 12% the following year could not utilise the excess FTCs from year one against the slight shortfall in year two, and tax could therefore be payable on the GILTI in year two.

Modelling the impact of FTCs and GILTI will be highly complex, particularly given the wider changes taking place to the international tax environment that mean domestic tax systems are likely to continue to change.

FDII

FDII is broadly the mirror image of GILTI. Whilst GILTI subjects foreign earnings to US tax, FDII subjects certain US earnings to a special tax regime, where those earnings have been generated from overseas.

FDII broadly applies to income arising from three types of activity:

- sales or other dispositions of property to a foreign person for foreign use;
- the licence of intangibles to a foreign person for foreign use; and
- services provided to a person located outside the US.

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FDII works by subjecting income from these activities to US tax, but allowing a deduction of 37.5% of that income (reduced to 21.875% from 2026). This effectively produces a tax rate of 13.125% (16.406% from 2026) and is available to both US and non-US parented groups.

In a world where low tax regimes are under challenge, the FDII regime provides a new option for businesses with US operations. If a company has intangibles located in a jurisdiction that may not be sustainable, potentially due to GILTI or because of changes introduced by the base erosion and profit shifting (BEPS) project, they may consider restructuring to move that intellectual property and income to the US and suffer taxation at a modest rate.

There has been some discussion on whether FDII is effectively a form of patent box. This is important because of the view of some that FDII does not comply with the characteristics for BEPS-compliant patent boxes. It is, therefore, possible that the FDII regime could be subject to a WTO challenge, although this is unlikely to have any effect in the near term.

What should UK tax professionals do?

The GILTI and FDII regimes are highly unusual and their introduction is nothing like the introduction of many other changes, which often build upon regimes that exist in other tax systems. Businesses should therefore go through a period of assessing the potential impact of these rules.

As a result, UK professionals working with groups with a US presence would be well advised to undertake the following:

- Devote time to understanding the rules.
- Work with affected businesses to analyse the implications and the potential costs of GILTI, along with the potential opportunities presented by FDII.
- Where changes to business models are proposed in light of GILTI and FDII, analyse the UK tax implications. ■

For related reading visit www.taxjournal.com

- ▶ US tax reform: practical aspects (Miles Humphrey & Mark Saunderson, 14.6.18)
- ▶ US tax reform: examining the Tax Cuts and Jobs Act of 2017 (Donald L. Korb & Andrew Solomon, 11.1.18)