taxnotes® international

Volume 90, Number ■ May 21, 2018

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Reprinted from *Tax Notes International*, May 21, 2018, p. 943

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In this article, the authors discuss the new U.S. global intangible low-taxed income rules, highlight uncertainties and potential inequalities between the treatment of individual and corporate taxpayers, and consider potential planning techniques to mitigate the consequences of those rules for U.S. individual shareholders.

The Tax Cuts and Jobs Act (P.L. 115-97) that President Trump signed into law on December 22, 2017, affects many areas of U.S. domestic and international tax planning. The international changes were portrayed as a move to a territorial tax system (implying foreign-derived business income would no longer be subject to U.S. taxation) with reduced tax rates. In fact, for many individual taxpayers with non-U.S. operations, the new rules result in both increased tax rates and the end of any meaningful ability to defer U.S. taxation until profits are actually paid into the United States.

This article illustrates the authors' understanding of the new global intangible low-taxed income rules, highlights uncertainties and potential inequalities between the treatment of individual and corporate taxpayers, and considers potential planning techniques to mitigate the consequences of these rules for U.S. individual shareholders.[1]

Background

Under the GILTI rules in new section 951A, U.S. shareholders in a controlled foreign corporation[2] must annually include in income their share of the CFC's net CFC-tested income, regardless of whether the CFC actually distributes any cash to the U.S. shareholders. While U.S. shareholders of CFCs have long been subject to a similar inclusion under the subpart F rules on specific passive and related-party income earned by the company, the GILTI rules greatly expand the scope of income on which U.S. CFC

[1]For a summary of GILTI and its potential complexities, see Jasper L. Cummings, Jr., "GILTI Puts Territoriality in Doubt," *Tax Notes*, Apr. 9, 2018, p. 161.

[2]While beyond the scope of this article, the TCJA significantly increased the number of CFCs by changing several definitional rules.

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shareholders are subject to immediate U.S. tax. Based on the authors' experiences with clients, GILTI includes nearly all active and operating income that before 2018 would not have been subject to U.S. tax until actually paid to the U.S. shareholder.

Given the title of the statute ("Global Intangible Low-Taxed Income Included in Gross Income of United States Shareholders"), taxpayers and advisers can be forgiven for thinking the rules apply only to income earned by a CFC that is both derived from intangibles and earned in low-tax jurisdictions. In fact, the GILTI rules apply to almost any income earned by a CFC that is not otherwise immediately subject to tax as passive or related-party income under the subpart F rules, including income that typically would be considered active or operating income. That may be the case even if the CFC has significant tangible operating assets and pays a high effective foreign tax rate.

Example 1. A U.S. individual (Owner) owns 52 percent of a global hospitality group (Hotel Group) that operates hotels through local subsidiaries in foreign jurisdictions; the local subsidiary structure is required in most locations for licensing and regulatory reasons. Hotel Group also has a Dutch group company (IP Co.) that has owned and licensed the worldwide intellectual property associated with Hotel Group's brand for approximately 15 years; IP Co. has major operations in the Netherlands, where its employees are engaged in the day-to-day management of the IP.[3] The business has operated for several years, and many of the hotels owned by the local subsidiaries have been owned for over 15 years. As a result of depreciation, each subsidiary's adjusted basis in its hotel for U.S. tax purposes is not significant compared with the value of the hotels. The global business generates annual profits of $150 million.

GILTI Defined

GILTI is the amount by which a U.S. shareholder's net CFC tested income exceeds the U.S. shareholder's net deemed tangible income return for the tax year. The two important calculations, therefore, are a U.S. shareholder's pro rata share of a CFC's tested income (or tested loss) and net deemed tangible income return, both of which are determined for each CFC, although the results are aggregated at the U.S. shareholder level.

Tested income is a CFC's gross income less properly allocable deductions (determined under rules similar to those that allocate deductions for foreign base company related-party sales and services income under the subpart F rules). Tested loss, conversely, is the excess of a CFC's properly allocable deductions over its gross income. Specific amounts are excluded from tested income and tested loss, including income taken into account in determining a CFC's subpart F income,[4] dividends from related persons, foreign oil and gas income, and U.S. effectively connected income.

Net deemed tangible income return is effectively 10 percent of the U.S. shareholder's pro rata share of the qualified business asset investment (QBAI) of each CFC (other than QBAI of a tested loss CFC).[5] QBAI is the quarterly average of the CFC's aggregated adjusted bases in specified tangible property used in the CFC's trade or business and for which a depreciation deduction is allowable under section 167.[6] Adjusted basis is determined using the straight-line depreciation method.[7]

Because tested income, tested loss, and deemed tangible income return are determined for each CFC and aggregated at the U.S. shareholder level, global operating groups, such as for the hotel business in the examples, might experience unexpected adverse consequences.

Example 2. Hotel Group recently acquired a hotel in Barcelona through a Spanish subsidiary. The subsidiary's basis in the hotel is high but it is

[3] In this example, royalties received by IP Co. are not subpart F income under the exception in section 954(c)(6) as income properly allocable to non-subpart F, non-U.S. effectively connected income of a subsidiary.

[4] Subpart F income also is excluded if it qualifies for the subpart F high-tax exception. As a result, highly taxed subpart F income may now be more desirable than GILTI; it also is easier to qualify for because of the reduced U.S. corporate tax rate.

[5] Some interest expense also is deducted in determining the U.S. shareholder's pro rata share of 10 percent of QBAI.

[6] Specified tangible property is any tangible property used to produce tested income. Specific rules apply to dual-use property.

[7] Under (duplicate) section 951A(d)(3), a CFC that is a partner in a partnership takes into account its distributive share of the partnership's aggregate adjusted bases in the partnership's specified property.

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making a loss during the start-up phase. Most of Hotel Group's subsidiaries have a lower basis in their hotels and higher income, because they have been owned and operated longer. Because the determination of whether a CFC has tested income or loss (and its share of QBAI) is determined first for each CFC and then aggregated at Owner's level, Owner may have large amounts of GILTI from the longer-owned hotels and would be unable to include the basis of the Barcelona hotel in her QBAI (because the Spanish subsidiary would be a tested loss CFC). Further, almost all income of IP Co. is likely to be GILTI, because it presumably has few tangible assets. While the impact of the GILTI rules for Owner could be mitigated if the IP were held in the same CFC as hotel operating assets (particularly the Barcelona hotel), there may be tax consequences for a restructuring and liability and other nontax reasons to hold the assets separately.

The (Limited) High-Tax Exception

A sometimes misunderstood aspect of the GILTI rules is the high-tax exception, perhaps in part because of a common-sense interpretation of the phrase "low-taxed" in the statute. Foreign base company income that otherwise would be subject to immediate tax as subpart F income under the regular CFC rules is excluded from subpart F income if the taxpayer establishes that the income is subject to an effective rate of foreign income tax greater than 90 percent of the maximum tax rate specified in section 11 — that is, greater than 18.9 percent, which is 90 percent of 21 percent, starting in 2018. GILTI tested income excludes foreign base company income that otherwise would be subpart F under the regular CFC rules, even if that income is not taxed as subpart F income because of the high-tax exception.

Counterintuitively, that means a U.S. shareholder of a CFC in a high-tax jurisdiction could defer U.S. tax on income that would otherwise be subpart F or GILTI (for example, related-party rents or royalties). U.S. tax on that income would be paid only if amounts are actually distributed to the U.S. shareholder — that is, the same treatment that applied to active or operating income before the GILTI rules. That rather bewildering result seems difficult to reconcile with the general principles of the CFC and GILTI rules.[8]

Example 3. If IP Co. were subject to an effective rate of more than 18.9 percent (for example, if IP Co. were based in the United Kingdom rather than in the Netherlands), it may be preferable for its royalties to be restructured as subpart F income. If the royalty payments would otherwise be subpart F income and IP Co. could show it paid an effective rate of at least 18.9 percent on the royalties, Owner could defer paying U.S. tax on all the royalty income under both the subpart F and GILTI rules. Although Owner, as an individual U.S. shareholder, would not receive credit for U.K. corporate taxes paid absent a section 962 election (discussed below), she could defer individual U.S. tax (currently up to 37 percent) on that income and pay tax only if a dividend is paid, potentially at 20 percent qualified dividend rates.[9]

Foreign Tax Credits

A GILTI inclusion is treated as a regular subpart F inclusion under some other code sections, including some FTC rules.[10] Under new section 960(d), a U.S. corporation that is a U.S. shareholder in a CFC can claim a credit against its U.S. tax liability on GILTI for 80 percent of foreign taxes paid for a GILTI inclusion, based on the ratio of the GILTI inclusion to the U.S. shareholder's pro rata share of CFC tested income.[11] Actual distributions to a U.S. corporate shareholder of amounts attributable to a GILTI inclusion generally should not result in further U.S. tax

[8]Depending on the answer to some questions, such as the availability of a GILTI deduction under section 250 for individual taxpayers making a section 962 election, subpart F income might be preferable to GILTI, even if taxed immediately to the U.S. shareholders. *See* Paul C. Nylen, "Wait, We Want Subpart F Inclusions Now?" *Tax Notes*, Apr. 16, 2018, p. 327.

[9]A dividend from a CFC to an individual U.S. shareholder would be a qualified dividend if the CFC is eligible for benefits under a comprehensive income tax treaty with the United States that includes an exchange of information provision (which should include a dividend from a U.K. company).

[10]For example, a GILTI inclusion is treated as a subpart F inclusion for the previously taxed income and basis adjustment rules, as well as section 1248, which recharacterizes gain on the disposition of a CFC as dividend income to the extent of the CFC's previously untaxed earnings and profits.

[11]After determining its inclusion percentage, the U.S. corporation calculates its U.S. tax liability on the GILTI inclusion by grossing up the inclusion for (all) the foreign taxes paid and calculating its U.S. tax on that grossed-up amount.

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under the previously taxed income rules of section 959.

On its face, section 960(d) does not apply to U.S. individual shareholders. However, an individual U.S. shareholder (including a U.S. trust or estate) should be able to claim a credit for foreign taxes paid for a GILTI inclusion if the individual makes a section 962 election to be taxed as a U.S. corporation on the inclusion.[12] Section 962 was enacted in 1962, and according to its legislative history, was intended to place a U.S. individual who invested directly in a foreign corporation in the same position he would have been in had he invested in the foreign corporation through a U.S. corporation. As a result, while section 962 allows a U.S. individual CFC shareholder to claim a credit for his share of foreign taxes paid by the CFC, the double tax construct of investing through a U.S. domestic corporation is preserved by taxing the U.S. individual CFC shareholder at applicable dividend rates on actual distributions from the CFC in excess of the corporate tax paid.[13]

Example 4. Assume Owner is a U.S. corporation, rather than a U.S. individual, and has a GILTI inclusion of $90 on which foreign taxes of $10 have been paid (ignore for the moment the new GILTI deduction in section 250, described below). Based solely on these facts, Owner's U.S. tax liability on the GILTI inclusion is $21 (21 percent of the sum of $90 inclusion and the $10 gross-up) and it can credit 80 percent of the foreign taxes paid ($8), resulting in a residual U.S. tax liability of $13. Owner should not pay further U.S. tax when it receives an actual distribution of the $90 of cash attributable to the GILTI inclusion because it would be previously taxed income. If Owner distributes a dividend of $77 — that is, $90 of cash from the CFC less the $13 of residual tax paid — its individual U.S. shareholders would pay 20 percent tax on that dividend.

Using the same numbers, if Owner, a U.S. individual, makes a section 962 election, she will have the same residual U.S. tax liability ($13). However, when Owner receives an actual distribution of $90, she will be subject to further U.S. tax on $77 ($90 less $13 of tax paid) at either ordinary or qualified dividend rates. In other words, the individual shareholder who makes a section 962 election has two potential disadvantages compared with a C corporation shareholder:

- the dividend tax is imposed when the cash is actually paid from the CFC even if the U.S. individual reinvests the cash in an active business, whereas a U.S. C corporation shareholder could reinvest the cash and defer the shareholder level tax; and
- if the CFC is not in a jurisdiction that has an income tax treaty with the United States, the shareholder level tax might be imposed at ordinary income tax rates rather than the qualified dividend rate that applies to dividends from domestic C corporations.

In either case, the GILTI FTC is a single-year, separate basket credit and cannot be used against non-GILTI foreign income or carried forward or back by a U.S. corporate or individual shareholder.[14]

GILTI Deduction

A U.S. individual shareholder with a GILTI inclusion is further disadvantaged because it appears she may not qualify for the 50 percent GILTI deduction (reduced to 37.5 percent after December 31, 2025) available to U.S. corporations under new section 250.[15] While there is an argument that a U.S. individual shareholder should be allowed to claim the section 250 deduction if she makes a section 962 election, it is unclear if that was Congress's intention based on the section 250 legislative history. While not

[12]Because the top U.S. corporate tax rate for many years was close to the top U.S. individual tax rate, it frequently did not make sense for U.S. individual CFC shareholders to make a section 962 election. However, the significant reduction in the U.S. corporate tax rate has breathed new life into the election.

[13]There is a question whether a section 962 election automatically results in qualified dividend treatment regardless of whether the CFC qualifies for benefits under a U.S. income tax treaty because the election is intended to put a U.S. individual shareholder in the same position as if she had invested through a U.S. corporation, and a dividend from a U.S. corporation is a qualified dividend. *See* Jeffrey L. Rubinger and Summer Ayers Lepree, "Corporate Rate Cut Will Affect Outbound Planning for U.S. Individuals," *Tax Notes*, Feb. 19, 2018, p. 1033.

[14]There are also some concerns with the way the section 78 gross-up on GILTI is basketed for FTC purposes. *See* Elizabeth J. Stevens and H. David Rosenbloom, "GILTI Pleasures," *Tax Notes Int'l*, Feb. 12, 2018, p. 615.

[15]Section 250(a)(1)(B)(ii) requires the U.S. corporation to increase its GILTI inclusion by the section 78 gross-up. *See supra* note 11.

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determinative, the section 962 regulations disallow any "deduction of the U.S. shareholder" in calculating taxable income on which corporate tax is paid under the election.

That point may be (obliquely) referenced in the most recent IRS guidance on the section 965 transition tax: In accordance with Notice 2018-26, 2018-16 IRB 480, the section 962 regulations will be updated to reflect the determination that Congress intended that an individual U.S. shareholder should be able to deduct the transition tax "participation exemption" when calculating taxable income under section 962.[16] However, Notice 2018-26 says taxable income under section 962 will not be reduced by any other deductions.[17]

If a U.S. individual shareholder cannot claim the 50 percent GILTI deduction even if she makes a section 962 election, there will be disproportionately negative consequences for U.S. individual shareholders in CFCs as compared with U.S. corporate investors.

Example 5. Using the numbers from Example 4, if Owner is a U.S. corporation, it deducts 50 percent of its GILTI inclusion of $100 ($90 plus the $10 gross-up for foreign taxes paid), or $50. It then calculates its U.S. tax on that amount (21 percent of $50, or $10.50) and can credit 80 percent of the foreign taxes paid ($8) against that amount, resulting in a residual U.S. tax liability of $2.50.[18] A U.S. individual shareholder in Owner would be taxed at 20 percent on a dividend from Owner of $87.50 ($90 cash less $2.50 U.S. tax), or $17.50. The tax burden in that case would be $30 ($10 of foreign tax, $2.50 U.S. corporate tax, and $17.50 U.S. shareholder tax).

On the other hand, if Owner, as a U.S. individual, cannot claim a section 250 deduction even if she makes a section 962 election, her residual U.S. tax liability on her GILTI inclusion remains $13 as in Example 4. Further, when $90 of cash is actually distributed, she would pay $15.40 in U.S. dividend tax (20 percent of $77), assuming qualified dividend rates apply. The tax burden in that case is $38.40 ($10 of foreign tax, $13 of U.S. corporate tax, and $15.40 of dividend tax) and the tax burden could be higher if the CFC is not in an income tax treaty jurisdiction. Clearly, Owner is not in the same position she would have been in if she owned the CFC through a U.S. corporation.[19]

While those different results might encourage U.S. individual CFC shareholders to consider holding their interests through a U.S. corporation, it is not clear that makes sense from a policy perspective.

How to Climb Out of the Hole?

So, what is an individual U.S. shareholder of a CFC to do to escape the GILTI hole? Our clients are considering three broad options:[20]

- *Make a section 962 election*. A section 962 election is made on the individual U.S. shareholder's tax return, so this option is available until the shareholder files his 2018 tax return — that is, during 2019. If guidance were to confirm that the section 962 election allows an individual shareholder to claim the 50 percent GILTI deduction, this might be an optimal solution for many taxpayers.
- *Use a C corporation*. The U.S. individual could transfer her CFC shares to a new U.S. C corporation to obtain the favorable C corporation treatment (broadly, 50 percent GILTI deduction, 80 percent credit for foreign taxes paid, and deferral of shareholder level tax until a dividend is paid).[21] This strategy removes any doubt

[16]Briefly, the transition tax rates are calculated based on a deduction mechanism in section 965(c) called a "participation exemption."

[17]While Notice 2018-26 does not reference section 250, it could very well be read to preclude U.S. individuals from claiming the section 250 deduction, even if they make a section 962 election.

[18]That calculation is the reason the legislative history to section 951A states that no residual U.S. tax will be due if the CFC pays a local tax rate of at least 13.125 percent — that is, it assumes the 50 percent GILTI deduction and an 80 percent FTC. For many reasons, including expense allocation rules and how the section 78 gross-up is basketed for FTC purposes, the calculations are almost certainly not nearly that straightforward for a U.S. corporate shareholder — and for an individual U.S. shareholder, the legislative history is simply inaccurate.

[19]Similarly, it means the 13.125 percent local tax rate does not hold true for an individual U.S. CFC shareholder, even without the complexities for expense allocations and FTC baskets.

[20]Those options and any other planning possibilities must be considered based on each client's circumstances.

[21]Deferring the shareholder level tax may be easier said than done under domestic antideferral rules; both the accumulated earnings tax and the personal holding company rules apply a 20 percent tax to specific undistributed C corporation earnings. The IRS has already noted that those rules might require additional guidance, given the reduction in the corporate tax rate. *See* Emily L. Foster, "Corporate Tax Reform Could Require Additional Antiabuse Guidance," *Tax Notes*, Dec. 11, 2017, p. 1517; and Wesley Elmore, "Tax-Free Transactions Likely to Persist Despite Lower Rate," *Tax Notes*, Feb. 5, 2018, p. 724.

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regarding the effect of a section 962 election by an individual shareholder. However, once assets are in U.S. corporate solution, it might be difficult to extract them without tax, whereas a section 962 election can be made yearly. Many taxpayers are nervous about committing to a C corporation when a future Congress could simply increase corporate rates or remove the GILTI deduction and leave the client "trapped" in the structure. One taxpayer has compared this alternative as falling for the "teaser rate" offered by credit cards for a limited period that increases after the period expires. While it may be possible to partially undo this alternative without tax through an election to treat the corporation as an "S corporation," this is still a more inflexible structure than most individual CFC shareholder clients had before the TCJA was enacted.[22] Because GILTI crystallizes on the last day of the CFC's tax year, this alternative presumably can be implemented until December 31, 2018, for 2018 GILTI (assuming the CFC has a calendar-year tax year and transfers do not result in a short CFC year).

- *Eliminate CFCs entirely*. A more radical approach is to make check-the-box elections on the CFCs in the structure (assuming they are eligible entities) and move to a pure passthrough structure. This might be attractive to taxpayers who structured into a jurisdiction with a tax treaty with the United States for qualified dividend treatment and used hybrid instruments to minimize local taxation. Moving to a flow-through structure may eliminate local complexities and tax issues and ensure full FTC availability, subject to the new FTC baskets.[23]

  However, check-the-box elections to move from a corporate to a flow-through structure are taxable dispositions, so the value of the assets versus their basis to the CFC would need to be considered, because presumably any gain the CFC recognizes on the deemed liquidation would be either subpart F income or GILTI, as applicable.

While the GILTI rules are inherently complex, taxpayers are finding the lack of certainty on key points such as the section 962 election particularly challenging. Further, even if the rules were certain, it is difficult for taxpayers to make a reasoned decision regarding planning alternatives without complex modeling analyses to estimate adjusted bases of tangible depreciable assets, income earned, and available FTCs, particularly across complex group structures. While many observers (including in Congress) may think of the GILTI rules applying to large multinationals, in our experience, many individual U.S. shareholders have complex foreign group operating structures that the GILTI rules will disproportionately affect.

We also suspect that in many cases, while the U.S. C corporation and the section 962 election alternatives may have a December 31, 2018, deadline, any move to a passthrough structure likely should be done sooner rather than later because all GILTI earned in 2018 before the elections (including any gain on the elections) presumably will be taxed under the GILTI rules, which are highly unfavorable to U.S. individual shareholders as compared with U.S. corporations.

Conclusion

It is not clear that Congress intended U.S. individual shareholders in CFCs to be disadvantaged under the GILTI rules. However, that seems to be the consequence under the rules as drafted (which mirrors many other provisions in the TCJA). As a result, U.S. individual shareholders who will be subject to the GILTI tax should consider planning alternatives that may mitigate the effect of those rules, particularly on active or operating income. ■

[22] The conversion of a C corporation to an S corporation has other consequences (for example, under the built-in gains tax rules); further, S corporation shareholder restrictions preclude non-U.S. shareholders.

[23] While beyond the scope of this article, a favorable tax rate applies to foreign derived intangible income earned by a U.S. C corporation under section 250, so the complex question of whether overseas assets should be held in U.S. corporate solution still applies. Income earned through a foreign branch does not qualify for the reduced rate, however, so further planning might be required to qualify for the incentive.

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