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Welcome to the GILTI Party: First Set of Proposed Regulations Released

Treasury and the IRS released a "first set" of proposed regulations September 13, 2018 on issues related to new global intangible low-taxed income (GILTI).

Section 951A of the Internal Revenue Code (Code) requires US shareholders of controlled foreign corporations (CFCs) to include in taxable income each year their GILTI inclusion amount, which is based on a formula that includes certain items of income, loss, investment and expenses of the CFCs. The GILTI inclusion is reduced by 50% under Section 250 of the Code, resulting in an effective tax rate for corporate US shareholders of 10.5% (until 2026 and later years, when the reduction will be only 37.5%, for an effective tax rate of 13.125%).

The below summary provides an overview of GILTI, discusses key items contained in the proposed regulations, analyzes what this may mean for companies, and provides a tax policy roadmap for how we got here and where we are going. As tax reform implementation continues, taxpayers should expect more Treasury and IRS guidance and proposed regulations later this year, along with a gradual decline in legislative activity as lawmakers leave Washington DC for the campaign trail.

GILTI Overview

GILTI was introduced into the Code in last year's tax reform legislation, known as the Tax Cuts and Jobs Act (TCJA), as part of a reworking of the international tax provisions intended to encourage multinationals to retain intangible property manufacturing operations in the US and discourage tax base erosion that might otherwise result from the generally "tax free" treatment of offshore dividends under Section 245A of the Code. The GILTI inclusion was designed to be a "stick" that taxes currently in the US income of CFCs that exceeds a "normal" return on investment in tangible depreciable property. Despite the fact that the word "intangible" is used in the name of the new provision, a CFC does not actually have to generate income from intangibles to have an inclusion. Indeed, an inclusion can (and often will) result even in cases where there is little intangible property involved in the generation of income. In contrast, tax reform provided a "carrot" in the form of a reduced effective tax rate for US corporations' income from export sales, labeled foreign-derived intangible income (FDII).

In addition to the 50% deduction against GILTI provided by Section 250 of the Code, a corporate US shareholder generally can take as a credit against its GILTI tax liability 80% of its pro rata share of the non-US income taxes "properly attributable" to the portion of positive profits of its CFCs that it included in income, subject to certain other limitations. As a result, Section 951A has given rise to a number of questions about how the GILTI inclusion and related items, such as the foreign tax credit, will be calculated in practice.

Most of the uncertainty arises from the fact that, unlike subpart F income inclusions that are determined on a CFC-by-CFC basis, GILTI inclusions are determined at the shareholder level based on a formula that aggregates at the shareholder level certain "CFC tested items" of all CFCs in which the taxpayer is a US shareholder. Thus, the GILTI rules do not fit neatly into the existing architecture of the otherwise similar subpart F provisions.

What Is Not In the First Set of Proposed Regulations

The proposed GILTI regulations are described in Treasury's press release as a "first set" because they deal with only some of the issues raised by Section 951A. Additional proposed regulations dealing with important questions about other issues, including the computation of the foreign tax credit with respect to a GILTI inclusion and the determination of the Section 250 (FDII) deduction, are still in the works. Treasury has indicated that this additional guidance should be released by mid-November 2018. The proposed GILTI regulations also do not address how GILTI interacts with UBTI (unrelated business taxable income) for exempt organizations, although in Notice 2018-67, the IRS indicated that GILTI will be treated as a dividend for UBTI purposes and so generally not taxable.

What Is Included in the First Set of Proposed Regulations

This first set of proposed regulations explains the determination of the GILTI inclusion amount by a US shareholder and provides definitions for the various components of the GILTI formula. These definitions include the "CFC tested items"– that is, all items determined at the CFC level, including tested income, tested loss, QBAI, tested interest expense and tested interest income – as well as the aggregated US shareholder-level items of net CFC tested income and net deemed tangible income return.

The proposed regulations also include new proposed consolidated return regulations dealing with GILTI inclusions by US shareholders that are members of a consolidated group. Essentially, to determine a member's GILTI inclusion amount, it is first necessary to aggregate CFC tested items relevant to each group member that is a US shareholder in one or more CFCs. Then, a portion of each aggregate amount is allocated to each such member of the group so that the GILTI determination can be made at the shareholder level for each US shareholder. Three detailed examples are provided to illustrate how the rules work. In addition to providing greater administrative simplicity, reporting GILTI on a consolidated basis will likely result in better availability of foreign tax credits for consolidated groups, depending to some extent on how the next set of GILTI regulations deals with such issues.

The GILTI rules are particularly challenging for a domestic partnership that is a US shareholder in one or more CFCs, and for US persons who are partners in such a partnership and may or may not be US shareholders in the CFCs owned by the partnership (or in other CFCs). The proposed regulations adopt a bifurcated approach. The rules treat a domestic partnership as an entity with respect to partners that are not US shareholders of any CFC owned by the partnership, and those partners will take into income their distributive shares of the partnership's GILTI inclusion amount. In contrast, the rules treat a domestic partnership as an aggregate for purposes of partners that are themselves US shareholders with respect to one or more CFCs owned by the partnership, and those partners will determine their GILTI inclusions separately. Six examples are included in the proposed regulations regarding partnerships.

The proposed regulations also deal with the interaction of the GILTI rules with Code sections that defer deductions for certain expenses payable to or incurred with respect to a CFC until the items are paid, unless those items have been included in the gross income of a US shareholder. The inclusion of such items in net CFC tested income for GILTI purposes will suffice to permit the deduction of the items by the payor.

With regard to a CFC's qualified business asset investment (QBAI), which is one of the CFC tested items in the GILTI computation and key element of the US shareholder's net deemed tangible income return, the proposed regulations provide some detail on the anti-abuse provisions contained in Section 951A(d)(4). The rules disallow the benefit of a stepped-up basis in specified tangible property if the property has been held for less than 12 months during the testing period. This is aimed at preventing taxpayers from acquiring tangible property for the sole purpose of reducing their GILTI inclusion.

In addition, the proposed regulations contain rules to ensure that a US shareholder's use of a tested loss of a CFC to offset tested income of another CFC in the GILTI computation results in a commensurate reduction in the shareholder's basis in CFC stock.

Although the proposed regulations generally do not address foreign tax credit calculations, the preamble to the proposed regulations states that the future proposed regulations will assign the Section 78 gross-up attributable to foreign taxes deemed paid with respect to GILTI to the GILTI basket.

What This Means for Companies

US multinationals should be pleased that Treasury and the IRS have provided a degree of clarity regarding the practical application of Section 951A, particularly as to how GILTI inclusions are determined for members of a consolidated group and for partners in a domestic partnership. Although the continued lack of guidance on the foreign tax credit may be frustrating, at least a clear signal was given regarding the basketing of the Section 78 gross-up amount in a way that is favorable to taxpayers (within the limitations of the GILTI rules). Treasury and the IRS appear to be making a good-faith effort to produce regulations that will enable taxpayers to apply the GILTI rules with a reasonable degree of certainty, which is encouraging.

Capitol Hill Perspective: As the (Implementation) World Turns

As lawmakers prepare to hit the campaign trail in earnest over the coming weeks, Treasury and the IRS still have much work to do to implement significant TCJA provisions. This first set of GILTI regulations are the latest in a flurry of new rules that Treasury has released this year to fill in the details of the TCJA. Those regulations have dealt with several major provisions from TCJA, including the one-time tax on offshore earnings (which we have discussed here), executive compensation (discussed here) and rules for pass-through businesses (discussed here). Looking ahead, we expect more on GILTI. As noted above, Treasury officials plan to address how GILTI will interact with foreign tax credits as part of a broader overhaul of foreign tax credit regulations later this year. Moreover, regulators expect to issue guidance before the end of the year on the other two major international provisions in the TCJA: FDII and the base-erosion and anti-abuse tax (BEAT).

While the implementation of the TCJA by Treasury and the IRS continues to move at a brisk pace, a similar level of legislative activity from Capitol Hill lawmakers should not be expected in this mid-term election year. Though the House Ways and Means Committee approved the "Tax Reform 2.0" package of three bills on September 13, 2018, chances of those proposals becoming law this year are relatively low. Broadly speaking, the package:

1. Makes permanent the individual provisions in the TCJA
2. Addresses retirement security by creating a "Universal Savings Account" along with incentives for businesses to provide retirement plans to their employees
3. Provides tax benefits to start-up businesses to spur innovation

While the legislation is expected to reach the House floor for a vote in late September, it is not expected to make much headway if it reaches the Senate given the need for bipartisan support in the Upper Chamber. As such, the package mostly serves as a messaging exercise for House Republicans with mid-term elections less than two months away.

No doubt it will be important to keep monitoring how Treasury and the IRS implement TCJA provisions, making for a busy time in the months ahead.

Contacts

Jeff VanderWolk
Partner, Washington DC
T +1 202 457 6081
E jefferson.vanderwolk@squirepb.com

Matthew D. Cutts
Partner, Washington DC
T +1 202 457 6079
E matthew.cutts@squirepb.com

Donald V. Moorehead
Partner, Washington DC
T +1 202 457 5212
E donald.moorehead@squirepb.com

Linda E.S. Pfatteicher
Partner, San Francisco
T +1 415 954 0347
E linda.pfatteicher@squirepb.com

Mitch Thompson
Partner, Cleveland
T +1 216 479 8794
E mitch.thompson@squirepb.com

Patrick N. Kirby
Associate, Washington DC
T +1 202 457 5294
E patrick.kirby@squirepb.com