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New Guidance on Global Intangible Low-Taxed Income (GILTI)

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The primary policy goal of the 2017 Tax Cuts and Jobs Act (TCJA) was to create jobs for U.S. workers and voters by increasing U.S. business activity. The sweeping changes implemented by the TCJA include a number of domestic provisions designed to incentivize U.S. corporations and small businesses with reduced tax rates that will presumably boost products "Made in the USA."

The international provisions of the TCJA go even further. They provide incentives to companies that conduct international business operations from the U.S. and penalize U.S. taxpayers that have moved intangible property or operations overseas to controlled foreign corporations (CFCs). U.S. taxpayers need to get up to speed quickly on these complex new rules so they can take advantage of the incentives and mitigate the negative impact of the latest penalties.

Why you cannot afford to ignore the new rules

The global intangible low-taxed income (GILTI) rules that were enacted by the 2017 TCJA created a new anti-deferral regime. The GILTI regime requires U.S. shareholders of a CFC to include, as income, a deemed distribution equal to their allocable share of the earnings and profits that are considered GILTI earnings. The deemed distribution creates what is referred to as "phantom" income for U.S. taxpayers--money that taxpayers are taxed on even though they have not received any cash related to that income.

The acronym "GILTI" is somewhat of a misnomer since it is not limited solely to income from intangibles or low-taxed income. GILTI is often referred to as a "global minimum tax." From a high-level perspective, GILTI earnings include all of a CFC's income above a 10 percent return on fixed depreciable assets.

Real world examples

The policy goal of GILTI is to discourage U.S. companies from transferring intangible property and operations overseas to low tax jurisdictions. The

implications of the new regime reach much further and will impact businesses of all sizes that have overseas operations. Let's look at some examples:

EXAMPLE 1: Technology behemoths like Apple generate income throughout the world. Thanks to careful tax planning and the structure of its overseas operations, Apple has been able to allocate a ***significant*** portion of its global income to Ireland—a country whose effective corporate tax rate is much lower than the U.S. rate. Before tax reform was passed, Apple's overseas earnings were ***not*** subject to any U.S. tax unless Apple decided to bring that money back to the U.S. Now, thanks to tax reform and the GILTI regime, those earnings will be includible in Apple's U.S. taxable income each year as GILTI income.

EXAMPLE 2: An American brother and sister own an Australian corporation that operates a retail clothing store in Australia. The income earned in Australia is considered "trade or business income," and it is subject to a 30 percent tax rate in Australia. Until recently, that income was ***not*** subject to an anti-deferral regime. But in the new era of tax reform and GILTI, the U.S. siblings must now include the GILTI income from their Australian corporation on their U.S. tax returns each year--and treat it as ordinary income subject to a maximum 37 percent tax rate.

U.S. taxpayers that have interests in overseas corporations need to act quickly to determine the impact that the new GILTI regime will have on their 2018 U.S. tax returns--and future foreign operations. Given the sweeping changes that the TCJA had on the U.S. taxation of international transactions, taxpayers have had very little time to study and digest the changes, much less prepare for reporting and plan intelligently for the future.

Who is affected by new rules on GILTI?
The GILTI regime is very broad and impacts all industries and all U.S. taxpayers that have overseas operations.

Taxpayers in service industries and other enterprises that don't have significant fixed assets may be more heavily impacted by the new rules. That said, even taxpayers that ***do*** have significant fixed depreciable assets such as manufacturers will be impacted. For example, if a U.S. company's manufacturing subsidiary in China earns above a 10 percent return on fixed assets, then the U.S. parent company will incur a GILTI inclusion.

Are individual taxpayers responsible for reporting GILTI?
Yes. The GILTI rules apply to ***all*** U.S. taxpayers including individuals and trusts, not just corporations. Individuals and trusts face more punitive U.S. tax consequences than corporations do when it comes to GILTI income. This seems like an unintended consequence of U.S. tax reform, which is harsher on closely held businesses than it is on large corporate entities.

U.S. domestic corporation shareholders will be able to take a 50 percent deduction on their GILTI amount in 2018 (subject to limitations) and are entitled to an 80 percent deemed foreign tax credit. The effective rate on a corporate entity is therefore 10.5 percent (half of 21 percent) before the foreign tax credit. Taking into

account the 80 percent indirect foreign tax credit, having an effective foreign tax rate that is at least 13.125 percent on GILTI income would mean that a U.S. corporation would owe ***no*** U.S. taxes on GILTI.

By contrast, individuals and trusts are ***not allowed*** to take the 50 percent deduction or an indirect foreign tax credit. Since GILTI income is also treated as ordinary income, individuals and trusts are subject to a maximum 37 percent U.S. tax rate on GILTI income with no credit for taxes paid at the foreign corporate level.

Planning options for individuals and trusts
For U.S. individuals and trusts impacted by GILTI, there are several planning options to consider:

- Set up a U.S. corporation as a holding company for your CFC interests.
- File check-the-box elections to treat your interests in foreign corporate entities as pass-through entities for U.S. tax purposes.
- File a 962 election.

The §962 election effectively interposes a theoretical U.S. corporation between the U.S. individual or trust and the CFC. When a U.S. individual makes a §962 election, he or she will be subject to tax on their GILTI income at the 21-percent corporate rate and will also be eligible for the 80 percent indirect foreign tax credit mentioned above. When earnings are actually distributed from the foreign corporate entity, the taxpayer will again be subject to tax on the earnings less the U.S. taxes paid (as though a U.S. corporation were reducing its earnings & profits by the tax expense).

With respect to the §962 election, one important area of uncertainty remains: As of press time, the IRS has not yet provided the professional community with guidance about whether or not individuals that make the §962 election can claim the same 50 percent deduction on GILTI income that U.S. corporations can.

What has changed since tax reform was passed in late 2017?

1. New proposed regulations on GILTI were issued in September 2018.

1. See news flash.
2. See the regulations.

2. New forms for reporting GILTI income and calculating the GILTI deduction were finalized and published in December 2018:

1. Form 8992: U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI).
2. Form 8993: Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI).

3. New proposed regulations on the foreign tax credit – which affect the computation of the liability on GILTI – were published in November 2018.

1. See news flash.
2. See the regulations.

Carrot and stick approach
Recently issued proposed regulations have provided some clarity on the international provisions of the TCJA. The broad implications of those sweeping changes are still the same. FDII and GILTI together encourage the U.S. ownership of intangible property. GILTI also ensures that U.S. taxpayers with overseas operations, especially those without significant depreciable assets, have U.S. tax exposure.

As I **wrote last year**: "The TCJA uses a 'carrot and stick' approach to encourage companies to keep business activity and intangible property in the U.S. The **carrot**, of course, is FDII which incentivizes American companies to keep operations in the U.S. that could otherwise be centered overseas. The **stick** is GILTI which penalizes companies that move their intangibles or operations overseas – particularly when those intangibles or operations are shifted to low-tax jurisdictions, such as Ireland."

What can companies do to reduce their GILTI exposure going forward?
Companies faced with GILTI exposure have several strategies to consider:

- Review transfer pricing to minimize CFCs that hold depreciable business assets, but which are still generating losses.
- Push investments in new depreciable business assets to profitable CFCs.
- Analyze the impact of a check-the-box election to treat foreign corporate entities as pass-through entities for U.S. tax purposes.

What's next for GILTI?
The Treasury and IRS must decide whether or not individuals making the §962 election receive the 50 percent deduction on GILTI. This will have a big impact for many closely held businesses and is something for which taxpayers and their professional advisors need guidance.

The TCJA in its entirety, which includes a lower U.S. corporate tax rate, FDII, and GILTI will encourage U.S. taxpayers to leave some of their operations in the U.S. on a prospective basis. However, I do not think we will see taxpayers rushing to bring existing operations back to the U.S.

Conclusion
TCJA's international provisions have dramatically impacted U.S.-international taxation. The new reporting requirements and calculations, which are extremely complex, will put a significant burden on U.S. taxpayers. American taxpayers now have to determine very quickly how to file and report GILTI on their 2018 returns. Unfortunately, U.S. individuals and trusts are particularly impacted by these new rules and are subject to

higher tax rates than U.S. corporations are—even if those corporations have the same income. Proper planning and structuring can help mitigate the impact of GILTI, and U.S. taxpayers should review their options for dealing with GILTI prospectively.

If you or a colleague has questions about the impact of the GILTI on your business or investment, please don't hesitate to contact me at 714-361-7685 or John.Samtoy@hcvt.com.

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