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International Tax ADVISORY ■

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First Round of Proposed GILTI Regulations Avoids the Hard(er) Stuff

On September 13, the IRS and Treasury released proposed regulations under the global intangible low-taxed income (GILTI) provisions added by the Tax Cuts and Jobs Act of 2017 (TCJA). The GILTI regime is intended to ensure U.S. taxpayers pay at least some U.S. tax on low-taxed or untaxed income of a controlled foreign corporation (CFC), above a nominal return on hard assets. This set of proposed regulations focuses on computation of the GILTI inclusion, including related Subpart F rules and anti-avoidance provisions. Taxpayers must continue to wait for guidance on the GILTI foreign tax credit and deduction, though the IRS and Treasury anticipate that the proposed guidance on foreign tax credits will include rules for assigning the Section 78 gross-up for deemed paid taxes to the separate GILTI basket.

Background

For tax years beginning after December 31, 2017, Section 951A requires U.S. shareholders of CFCs to include in current income their share of GILTI, somewhat similar to Subpart F inclusions. Unlike other Subpart F inclusions though, a U.S. shareholder's GILTI inclusion is determined on an aggregate basis taking into account all CFCs of the shareholder.

C corporations are permitted a credit for foreign taxes on GILTI under Section 960(d), subject to an 80% limitation, separate basketing, and no carryover. Corporate U.S. shareholders can also claim a deduction under Section 250 for up to 50% of the GILTI inclusion amount for a U.S. shareholder that is a C corporation, resulting in a 10.5% effective tax rate for GILTI. (The deduction cap decreases to 37.5% for tax years after 2025.)

Proposed Regulations

Overview

The proposed regulations chiefly address definitional aspects of computing the GILTI inclusion amount, including (1) determining CFC-level amounts such as tested income, tested loss, and qualified business asset investment (QBAI), and interest expense; (2) figuring the U.S. shareholder's pro rata share of CFC-level items; and (3) applying aggregation rules to arrive at the GILTI inclusion. In addition to general guidance applicable to all U.S. shareholders, the proposed rules offer special provisions for situations involving preferred stockholders, partners and partnerships, and consolidated groups. The proposed regulations also include several anti-abuse provisions and announce GILTI-specific reporting requirements.

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Computation of GILTI inclusion

GILTI inclusion = Net tested CFC income – Deemed tangible income return

Net tested income is the excess, if any, of the aggregate of the U.S. shareholder's pro rata share of tested CFC income over the aggregate of the shareholder's pro rata share of tested CFC losses. Tested CFC income (or loss) means gross income—excluding effectively connected income under Section 952(b), Subpart F income, income excluded from foreign base company income and insurance income by reason of the high-tax kickout under Section 954(b)(4), related-party dividends, and foreign oil and gas income—less properly allocable deductions. The proposed regulations rely heavily on existing Subpart F rules, with "appropriate modifications." For example, a shareholder's pro rata share is generally determined in accordance with Section 951(a)(2), and Sections 1.952-2 and 954(b)(5) apply to identify and allocate deductions to determine tested income or loss.

Deemed tangible income return means 10% of the shareholder's pro rata share of the QBAI of each CFC, reduced by "specified interest expense." QBAI means the average of a CFC's aggregate quarterly adjusted bases in specified tangible property used in a trade or business and subject to Section 167 depreciation. The adjusted basis of specified tangible property must be determined under the alternative depreciation system of Section 168(g), regardless of when the property was acquired or placed in service. The proposed regulations clarify that a shareholder has QBAI only from tested-income CFCs, not from tested-loss CFCs. A tested-income CFC that is a partner in a partnership takes into account its share of a partnership's adjusted basis of specified tangible property in computing the CFC's QBAI if such property is used to produce tested income. The CFC partner's share of basis is based on the amount of its share of gross income from the property included in tested income relative to total income produced by the property.

A shareholder's specified interest expense is the excess of its aggregate pro rata share of tested interest expense of each CFC over its aggregate pro rata share of tested interest income of each CFC. Special provisions apply to determine specified interest expense for eligible CFCs within the meaning of Section 954(h)(2) and insurance companies within the meaning of Section 953.

Domestic-partnership-related rules

Section 951A contains no guidance for domestic partnerships that own CFCs. Proposed Section 1.951A-5 would provide rules for domestic partnerships and their partners (as well as S corporations, which are treated as partnerships for purposes of Section 951A and Subpart F), using a blended aggregate and entity approach. A domestic partnership is treated as an aggregate for partners that are U.S. shareholders of a CFC owned by the partnership, and such partners take into account their proportionate share of tested income, tested loss, QBAI, tested interest income, and tested interest expense. For partners that are not U.S. shareholders of a CFC owned by the partnership, the partnership is treated as an entity, with such partners taking into account their distributive share of the GILTI inclusion computed at the partnership level. The IRS and Treasury request comments on this Frankenstein's monster approach to domestic partnerships with CFCs.

Anti-abuse rules

Among the anti-abuse provisions in the proposed regulations is an amendment to Section 1.951-1, which would require a "facts and circumstances" approach to allocate Subpart F and, consequently, GILTI income. This proposal is meant to address avoidance structures that improperly benefited from fair-market-value-based allocation. The amended regulations would also disregard transactions or arrangements that are part of a plan with the principal purpose of reducing Subpart F or GILTI inclusions.

The IRS and Treasury propose two specific anti-abuse measures in connection with QBAI. First, specified tangible property is disregarded in computing a tested-income CFC's QBAI if the CFC (1) acquires the property with the principal purpose of reducing GILTI inclusion; and (2) holds the property temporarily but as of at least one quarter-end. Property held for a less-than-12-month period that includes at least one quarter-end is treated as temporarily held and acquired with the requisite purpose. Second, the proposed regulations would deny the benefit of stepped-up basis in specified tangible property transferred between related CFCs during the period before the transferor CFC's first GILTI inclusion year; as a result, the transferee CFC's QBAI is computed without the increased basis.

What else?

What is clear is that recent proposed regulations are barely a preview of coming attractions in GILTI guidance. While guidance is generally welcome in this brand-new area—the application of GILTI on a group basis for consolidated groups is helpful instruction, for example—even this first round of "basic" definitional and computational rules involve considerable complexity. Some question the administrative shortcut of relying so heavily on Subpart F rules, observing that computational mechanisms in the Subpart F context could create unfair distortions in the GILTI area. For example, disallowance of loss carryovers in Section 1.952-2, which the GILTI rules employ to determine tested income/loss, could result in excessive taxation of a tested-loss CFC that subsequently becomes a tested-income CFC.

The IRS and Treasury promise future regulations packages on the GILTI foreign tax credit and Section 250 deduction and even kick a few GILTI inclusion issues down the road. Comments are requested on a host of issues, including items covered and uncovered in the proposed regulations—a signal that the final rules could look significantly different. In managing continuing uncertainty surrounding GILTI, taxpayers should also take note of the IRS and Treasury's apparent hostility to "interim planning" that might otherwise reduce their exposure under the new international landscape post-TCJA.

For more information, please contact Edward Tanenbaum at 212.210.9425 or Heather Ripley at 212.210.9549.

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