GILTI Pleasures

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In this article, the authors attempt to solve the policy puzzle behind the global intangible low-taxed income rules in the Tax Cuts and Jobs Act.

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The fancy new international provisions in the Tax Cuts and Jobs Act (P.L. 115-97) offer potentially endless amusement and discovery as we all decipher what Congress actually did and think about the why. The why, of course, is elusive and in many respects may just have to wait.

We strain to understand, for example, the use of the very same concept of qualified business asset investment (QBAI) as the threshold for both global intangible low-taxed income (GILTI) and foreign-derived intangible income (FDII). In simple terms, GILTI is something taxpayers would prefer not to have, whereas FDII is a taxpayer benefit. GILTI (bad) can only be earned by a controlled foreign corporation and generally consists of income in excess of a deemed return on the CFC's tangible assets. FDII (good) can only be earned by a domestic corporation and generally consists of income in excess of a deemed return on the domestic corporation's tangible assets. Tethering both GILTI and FDII to tangible asset investment would seem to invite taxpayers to increase tangible investments abroad, in CFCs (thereby raising the threshold for GILTI), and to reduce tangible investments in the United States, in domestic corporations (thereby lowering the threshold for FDII).

The promotion of foreign tangible investments coupled with an encouraged reduction in U.S. tangible investments was not among the advertised goals of the legislation (to put the point mildly). What is the rationale for this odd policy choice?

While we await the inevitable post hoc rationalizations, we can entertain ourselves with the GILTI rules, which, on their own, are a bit of a puzzle. They effectively add to the code an analogue to subpart F, taxing U.S. shareholders on income of CFCs in excess of: (a) 10 percent of a shareholder's aggregate QBAI; (b) subpart F income; (c) income effectively connected with a U.S. trade or business; (d) gross income excluded from subpart F because it is highly taxed; (e) dividends received from a related person; (f) foreign oil and gas extraction income; and (g) the deductions (including taxes) properly allocable to GILTI.

For this purpose, all CFCs are combined, including CFCs with losses. GILTI included in a U.S. shareholder's gross income is generally treated in the same manner as subpart F income. There is a deemed paid credit for foreign tax imposed on the GILTI but only to the extent of 80 percent of available credits. GILTI has its own separate foreign tax credit limitation basket, and excess credits may not be carried back or forward

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to other tax years. A U.S. corporate shareholder is entitled to a deduction for 50 percent of the "GILTI amount" plus "the amount treated as a dividend . . . under section 78 which is attributable to the [GILTI amount]." That percentage drops to 37.5 percent for taxable years beginning after December 31, 2025. Individual shareholders are not a focus of this legislation, and do not benefit from the special deduction.

Since GILTI is net of foreign tax, and since the 50 percent deduction is framed as 50 percent of GILTI plus 50 percent of the section 78 gross-up for foreign tax, there is a strong statutory suggestion that the section 78 gross-up is not GILTI for foreign tax credit limitation purposes, even when the foreign tax is attributable exclusively to GILTI. This conclusion is, again to put it mildly, rather strange. Treas. reg. section 1.904-6(b)(3) seems to point in the opposite direction, but it is a regulation and, of course, predates the statute. And some aspects of the (relatively scant) legislative history support the conclusion that the gross-up is not within the GILTI basket. The Senate amendment would have modified section 78 to provide, in pertinent part, that the gross-up "be treated for purposes of this title (other than section 960) as an addition to . . . global intangible low-taxed income." Neither this language nor any similar provision appears in section 78 as amended by the Conference Report (H.R. Rep. 115-466), implying a conscious choice not to treat the gross-up as GILTI.

If GILTI and the gross-up are separately basketed for foreign tax credit limitation purposes, unintuitive consequences ensue. Assume a U.S. corporate shareholder owns 100 percent of a CFC that has no QBAI, no deductions, and no other income besides 10,000 of GILTI. The CFC pays foreign tax at a rate of 13.125 percent, the supposed "break-even" rate under the GILTI statute. If the gross-up *were* included in the GILTI basket, the computation would be as follows:

GILTI = 10,000

Foreign Tax = 1,312.5

U.S. Shareholder's GILTI Inclusion = 10,000 - 1,312.5 = 8,687.5

Section 78 Gross-Up = 1,312.5

GILTI Deduction = 50% x (8,687.5 + 1,312.5) = 5,000

GILTI Basket:

Net Income = (8,687.5 + 1,312.5) - 5,000 = 5,000

Tentative U.S. Tax = 21% x 5,000 = 1,050

Foreign Tax Credit Limitation = 1,050 x (5,000/5,000) = 1,050

Foreign Tax = 80% x 1,312.5 = 1,050

Creditable Foreign Tax = 1,050

Excess Credit = 0

But if the gross-up is instead basketed separately from GILTI, various alternative computations are plausible on the statutory language. One alternative might be:

GILTI = 10,000

Foreign Tax = 1,312.5

U.S. Shareholder's GILTI Inclusion = 10,000 - 1,312.5 = 8,687.5

Section 78 Gross-Up = 1,312.5

GILTI Deduction = 50% x (8,687.5 + 1,312.5) = 5,000

GILTI Basket:

Net Income = 8,687.5 - 5,000 = 3,687.5

Tentative U.S. Tax = 21% x 3,687.5 = 774.375

Foreign Tax Credit Limitation = 774.375 x (3,687.5/3,687.5) = 774.375

Allocable Foreign Tax = 80% x [1,312.5 x (8,687.5/10,000)] = 912.1875

Creditable Foreign Tax = lesser of 774.375 or 912.1875 = 774.375

Excess Credit = 912.1875 - 774.375 = 137.8125 (*no carryforward/carryback*)

General Basket:

Net Income = 1,312.5

Tentative U.S. Tax = 21% x 1,312.5 = 275.625

Foreign Tax Credit Limitation = 275.625 x (1,312.5/1,312.5) = 275.625

Allocable Foreign Tax = 1,312.5 x (1,312.5/10,000) = 172.265625

Creditable Foreign Tax = lesser of 275.625 or 172.265625 = 172.265625

Additional U.S. Tax = 275.625 - 172.265625 = 103.359375

So U.S. tax on GILTI is fully offset, with an excess credit of 137.8125 that cannot be carried over to other years, but residual U.S. tax of 103.359375 is due on the gross-up amount in the general basket. The "break-even" rate for GILTI under this alternative calculation is below

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13.125 percent (closer to 11.5 percent). The result in the general basket is consistent with intuition: Includable foreign income taxed at a rate below the U.S. rate should be subject to residual U.S. tax.

Another, perhaps better, alternative computation would be:

GILTI = 10,000

Foreign Tax = 1,312.5

U.S. Shareholder's GILTI Inclusion = 10,000 - 1,312.5 = 8,687.5

Section 78 Gross-Up = 1,312.5

GILTI Deduction = 50% x (8,687.5 + 1,312.5) = 5,000

GILTI Basket:

Net Income = 8,687.5 - [5,000 x (8,687.5/10,000)] = 4,343.75

Tentative U.S. Tax = 21% x 4,343.75 = 912.1875

Foreign Tax Credit Limitation = 912.1875 x (4,343.75/4,343.75) = 912.1875

Allocable Foreign Tax = 80% x [1,312.5 x (8,687.5/10,000)] = 912.1875

Creditable Foreign Tax = lesser of 912.1875 or 912.1875 = 912.1875

Excess Credit (Limitation) = 0

General Basket:

Net Income = 1,312.5 - [5,000 x (1,312.5/10,000)] = 656.25

Tentative U.S. Tax = 21% x 656.25 = 137.8125

Foreign Tax Credit Limitation = 137.8125 x (656.25/656.25) = 137.8125

Allocable Foreign Tax = 1,312.5 x (1,312.5/10,000) = 172.265625

Creditable Foreign Tax = lesser of 137.8125 or 172.265625 = 137.8125

Excess Credit (Limitation) = 172.265625 - 137.8125 = 34.453125

In this case, U.S. tax is fully offset, with no excess credits, in the GILTI basket. There is, however, an excess credit in the general basket of 34.453125, which can be carried over to other tax years.

The difference between the second and third computations lies in the allocation of the GILTI deduction between the two baskets for purposes of the foreign tax credit calculation. A superficial reading of the statute implies that the deduction applies to both GILTI and the gross-up amount and should be allocated ratably between them, as in the third computation. But Congress did not write the Tax Cuts and Jobs Act on a blank slate. One could reasonably argue that under Treas. reg. section 1.8618 the deduction is attributable entirely to GILTI and so belongs entirely in the GILTI basket, as in the second computation. Furthermore, although both the second and third computations allocate foreign tax between the GILTI and general baskets, the preexisting regulatory framework, specifically Treas. reg. section 1.9046, might be read to treat *no* foreign tax as properly attributable to the gross-up. On that approach there would be a full U.S. tax liability for 21 percent of the gross-up amount.

Regardless of which computation is correct, separate basketing of GILTI and the gross-up leads to curious results. Elements of the new law are intricate and puzzling; their interaction with old law will produce surprises, complexities, and — perhaps to the chagrin of Congress — planning opportunities. The unintended consequences will be most interesting. In (nearly) the words of that famous American philosopher, Yogi Berra, we will observe a lot by just watching. ■

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