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Navigating QBAI Quirks of the GILTI Regulations

By Clark Armitage, Jonathan Brenner, and Josiah Child[*]

Yes, the proposed GILTI regulations didn't answer some of the tough questions, particularly those surrounding the calculation of foreign tax credits.[1] But the regulations do address other critical issues and suggests the general approach of Treasury and the Internal Revenue Service to drafting regulations under the 2017 tax act (''Act'').[2] That approach is to adopt regulations that Treasury and the IRS believe are consistent with the overall statutory framework, and not regulations that unduly defer to specific statutory language that seems out of sync. As additional proposed regulations are issued (the anticipated release schedule is outlined near the end of this report), this approach undoubtedly will help taxpayers in some ways and hurt them in others. The statute and its legislative history produce a stark need for guidance, and where that guidance is adverse to taxpayers, there may be little room to challenge regulations as *ultra vires*. Most taxpayers will need to engage in self-help through structural solutions.

In this report, we summarize certain key aspects of the proposed GILTI regulations relating to a controlled foreign corporation's qualified business asset investment (QBAI). GILTI generally requires current inclusion, by the U.S. shareholders of a CFC, of most categories of active CFC income.[3] A key exception is that a deemed return equal to 10% of QBAI, less specified interest expense, is generally exempt from current U.S. taxation.[4] While this amount may bear non-U.S. taxes, it is permanently exempt from U.S. tax in the hands of corporate U.S. shareholders, due to the dividends-received deduction in new §245A. The amount is also generally eligible for deferral in the hands of individual U.S. shareholders, who must take it into income only when received or recaptured as dividend income under §301 or §1248 (e.g., after return of income previously taxed under §965).[5] Accordingly, for both corporations and pass-throughs, there is great interest in reducing GILTI by increasing QBAI.

QBAI is generally depreciable tangible property owned and used to produce GILTI.[6] While a U.S. shareholder's GILTI inclusion is its aggregated share of tested income and loss from *all* CFCs, QBAI is determined separately for *each* CFC.[7] A CFC with a tested loss is deemed to have zero QBAI, regardless of how much depreciable tangible property it owns.[8]

[*] Clark Armitage and Jonathan Brenner are Members of Caplin & Drysdale's International Tax Group located, respectively, in the firm's Washington, D.C., and New York City offices. Also in New York is Josiah Child, who is an Associate with the Group.

[1] *See* Notice of Proposed Rulemaking, *Guidance Related to Section 951A (Global Intangible Low-Taxed Income)* 83 Fed. Reg. 51,072 (Oct. 10, 2018) (''proposed GILTI regulations'').

[2] Pub. L. No. 115-97 (Dec. 22, 2017). The 2017 tax act was referred to during legislative proceedings as the Tax Cuts and Jobs Act (TCJA).

[3] §951A(a) (inclusion), §951A(c) (tested income and loss). All section references are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations thereunder, unless otherwise indicated.

[4] §951A(b)(1)(B), §951A(b)(2) (net deemed tangible income return).

[5] §959 (ordering rules applicable to amounts distributed).

[6] §951A(d) (defining QBM).

[7] §951A(d)(1).

[8] §951A(d)(2)(A) (defining ''specified tangible property'' eligible to be treated as QBAI to include only property ''used in the production of tested income''). As discussed in more detail below, the Conference Report and the proposed GILTI regulations interpret this to mean that a CFC has zero QBAI if it incurs a tested loss. Prop. Reg. §1.951-3(b)(1) (''A tested loss CFC has no qualified business asset investment.'').

These statutory rules produce a cliff effect. Take for example the U.S. shareholder of an unleveraged CFC that owns and uses $100 million of depreciable tangible property to produce GILTI. That shareholder may exclude up to $10 million from its aggregate GILTI inclusion if the CFC earns just *$1 of tested income*. If, however, the CFC earns *$1 of tested loss*, none of the property qualifies as QBAI and the $10 million exemption for that taxable year is permanently lost.

The QBAI rules thus put a premium on monitoring the tested income position of each CFC with material QBAI-eligible property. U.S. taxpayers may be able to plan around some of the resulting distortions. But restructuring and monitoring of outbound operations will require care. The QBAI cliff effect also has implications for CFCs with both subpart F income and GILTI tested income or loss. This report details some of these considerations.

DISCUSSION OF THE LOSS CFC QBAI CLIFF EFFECT

At a Loss With What to Do With QBAI

The proposed GILTI regulations confirm the widely held understanding that QBAI of a loss CFC cannot be used to offset a U.S. shareholder's tested income from profitable CFCs:

> Consistent with the statute and the conference report accompanying the Act (''Conference Report''), the proposed regulations clarify that a tested loss CFC does not have specified tangible property. See H.R. Rep. No. 115-466, at 642, fn. 1536 (2017) (Conf. Rep.) and proposed §1.951A-3(b), (c)(1), and (g)(1). Accordingly, for purposes of calculating its GILTI inclusion amount, a U.S. shareholder does not take into account the tangible property of a tested loss CFC in calculating its aggregate pro rata share of QBAI, its deemed tangible income return, or its net DTIR.[9]

This odd outcome — which seems to penalize U.S. shareholders of CFCs that have performed poorly — applies even if the CFC incurs a minimal loss. The difference between $1 of tested income and $1 of tested loss may thus be stark.

Although the proposed regulations adopt some principles to minimize the importance of tax planning on substantive U.S. tax outcomes, this is not one of them. The rule puts a premium on forward thinking about the location of QBAI within particular CFCs, and developing robust projections about a CFC's expected results.

Taxpayers with substantial (potential) QBAI in a loss entity may seek to free it up so that it can be used to offset net CFC tested income from other, profitable entities. The alternatives typically involve either moving beneficial ownership of QBAI into a profitable entity, or restructuring foreign operations to allow different entities' profit and loss to be netted at the CFC level.

The implementation of any solution, however, may have its own consequences for U.S. shareholders under the subpart F and GILTI regimes. It also may have legal and tax implications under foreign law. For example, a U.S. group could:

- Make a check-the-box election to disregard one or more subsidiary CFCs from a parent CFC. Since this election would be effective only for U.S. tax purposes, it may be useful in addressing foreign-law rigidities. Vigilance may be required under the anti-hybrid rules.
- Restructure CFC operations by contributing QBAI-intensive operations to another CFC in exchange for stock, merging one CFC into another under foreign law, or conducting a similar reorganization.
- Transfer the QBAI to another CFC in a taxable transaction, if the transferee CFC can use the QBAI in its business. This typically would generate GILTI if the property is held at a gain, which should be modeled together with foreign tax consequences and U.S. tax shelter from the deemed 10% return on QBAI.
- Introduce new operations into the loss CFC to help it generate a profit. But be wary of taxation under §367 and loss recapture rules if the new operations arrive through an outbound transfer, as this transaction generally also would involve a trade-off between upfront U.S. taxes and shelter from the GILTI inclusion.

If outbound transfers are an option, U.S. corporations should keep in mind that QBAI held in their U.S. operations also affects their access to the preferential effective rate (now generally 13.125%) for foreign-derived intangible income (FDII). FDII deductions are potentially available only to the extent that a U.S. corporation earns income from foreign markets in excess of a 10% deemed return on QBAI without adjustment for specified interest expense.[10] Depending on the facts, this may or may not provide

[9] 83 Fed. Reg. 51,072 at 51,073.

[10] §250(b)(2)(B).

ISSN 0090-4600

an incentive to transfer QBAI to a CFC (e.g., if the U.S. business is at a loss, it may be advantageous to locate QBAI-based operations in a profitable CFC). Note that an FDII deduction may be available with respect to gain recognized on the transfer of assets to a CFC.

The above solutions all address the transition from a GILTI-less world to a GILTI one. For new investments, the lesson is to avoid isolating in a separate CFC capital-intensive businesses expected to produce losses. Similar considerations will need to be taken into account, most likely with more flexibility.

Passive Income Pitfalls

The proposed regulations also confirm that a number of counter-intuitive consequences will result from the inability to net a particular CFC's active tested income against its passive subpart F income. The most obvious consequence is the magnitude of a U.S. shareholder's current pickups from CFCs, which has first-order importance to U.S. corporations because GILTI and subpart F income are taxed at different effective rates. But the classification of a CFC's income as tested income or subpart F income also has second-order importance for a U.S. shareholder's access to QBAI.

For example, imagine that a wholly owned CFC has $101 of subpart F income offset by a $100 GILTI tested loss. Even though the CFC has $1 of earnings on a net basis, its U.S. shareholder would have a $101 subpart F inclusion, and may not be able to offset the $100 GILTI tested loss, unless it has other CFCs producing GILTI tested income. (If it is a corporate U.S. shareholder, the GILTI tested loss is less valuable even if it offsets GILTI tested income, due to the lower effective rate arising from the GILTI deduction.) Further, the U.S. shareholder will not be able to take into account any QBAI owned by the CFC because — even though the CFC produced $1 in profit overall — it incurred a GILTI tested loss.

It thus should be underscored that Subpart F income and GILTI are not netted at the CFC level, or really at all. The resulting dynamic produces an incentive for U.S. shareholders to classify a CFC's income as GILTI tested income rather than subpart F income. That incentive is reinforced by the cliff effect for QBAI, discussed above, because the CFC must have positive GILTI tested income (not just positive earnings and profits) in order for its U.S. shareholders to take its QBAI into account in reducing their GILTI inclusion. Conversely, the IRS generally will have an incentive to move activities into the subpart F income category — and an adjustment that eliminates a CFC's GILTI tested income will cause a total loss of its QBAI.

Supply Chain QBAI

Due to both effective rates and QBAI dynamics, U.S. groups should be cognizant of the ways in which the GILTI and FDII rules filter through transfer pricing agreements in their supply chains — in terms of both their own incentives and the IRS's. The impact likely will be highly fact-dependent, and could vary based on the business line and effective foreign tax rates.

For example, when negotiating and monitoring transfer pricing for payments to and from CFCs, U.S. groups should be aware of the cliff effect on QBAI that may occur when the CFC operates near the break-even mark or has volatile profits and losses. If a transfer pricing adjustment caused a CFC to incur a tested loss rather than earning tested income, loss of the entity's QBAI allowance could be a significant secondary consequence.

Before the OECD's Base Erosion and Profit Shifting project, limited-risk distributors, contract manufacturers, and similar supply-chain entities often earned a modest and predictable profit: The U.S. shareholder would contractually agree to limit the risk and liabilities of a new CFC. Distributors would be limited risk. Manufacturers would be contract manufacturers. Service providers, including contract-R&D shops, would be compensated on a cost-plus basis.

BEPS has made this outcome less certain. A foreign taxing authority or the IRS could seek to apply the OECD's DEMPE (development, enhancement, maintenance, protection and exploitation of intangibles) rules to assert that a contract-R&D shop controls development risk and so is entitled to a non-routine return. Similar assertions could be made for distributors and manufacturers. Due to the recent shift in effective tax rates, in many cases a foreign taxing authority may have greater incentive to make these arguments than the IRS. And with more upside comes greater potential for downside in years when the group as a whole does poorly. An increased potential for losses may create uncertainty about the placement of QBAI in a particular CFC.

Nonetheless, adhering to the traditional model could be helpful in ensuring that the entity's QBAI is available to the U.S. shareholder; a challenge by the IRS seems unlikely since routine returns at the CFC level generally should be acceptable on U.S. audit, at least to the extent they result in the allocation of extraordinary returns to a U.S. affiliate.

These arrangements are effective, of course, only if the CFC in question owns the property used in its business, either outright or under a long-term financing lease treated as beneficial ownership for U.S. tax purposes. Note, also, that the arrangements under which the CFC owns its QBAI could imply that it

ISSN 0090-4600

bears economic risk, and affect the strength of the DEMPE arguments available to a foreign tax authority.

Sharing Is Caring About Allocations

Even if a QBAI-rich CFC has tested income, a U.S. shareholder will benefit only to the extent the QBAI is allocated to the U.S. shareholder. Although a U.S. shareholder takes into account its ''pro rata'' share of QBAI, special rules apply (and may create disproportionate allocations) where the CFC has both common and preferred stock, or the U.S. shareholder's interest in the QBAI involves a partnership. The proposed rules create complexity, and potentially counter-intuitive results.

For example, a U.S. shareholder that holds common stock when the CFC has issued preferred stock could be deprived of much of its QBAI. The pro rata share rules generally allocate QBAI in the same manner as tested income, looking to how the shareholders would split the CFC's earnings on a hypothetical year-end distribution.[11] Preferred shareholders may attract a disproportionate share of a CFC's tested income, and therefore of its QBAI, though the amount disproportionately allocated to the preferred shareholders is limited to 10 times the CFC's tested income (above which it is ''excess QBAI'' allocable solely to the common).[12] An anti-abuse rule and other requirements govern the use of preferred stock to affect pro rata shares of QBAI.[13]

Likewise, if a CFC owns the QBAI through a partnership, a U.S. shareholder should be attentive to the rules governing allocations of adjusted basis in the partnership's QBAI, and how those rules filter through allocations of gross income from the property under the partnership agreement (taking into account the effects of §704(c)). Similar concerns may arise where a U.S. shareholder owns CFC stock through foreign or domestic partnerships. The possibility of disproportionate allocations of QBAI should be considered at each level of the holding structure.

Closing the Donut Hole

One way to increase QBAI, as noted above, is by engaging in a taxable transfer of depreciable assets from one CFC to another (or otherwise increasing basis in existing, currently owned tangible property that qualifies as QBAI). These basis-increasing transfers are potentially taxable in the applicable non-U.S. jurisdiction. They would also potentially give rise to U.S. tax because, had they occurred prior to December 31, 2017, they would have increased earnings and profits taxable under §965, and, if they occur later, they risk generating current GILTI inclusions.

But what if the transaction occurred after the later of the §965 testing dates (i.e., December 31, 2017), and before the effective date of GILTI? This might be the case for a CFC with a non-calendar year-end, since GILTI applies to the first taxable year beginning after December 31, 2017. If the basis-increasing transaction occurs after December 31, 2017 and before the 2018-ending fiscal year (say November 30, 2018), the transaction appears to be exempt both from §965 and from GILTI. QBAI would be increased with no attendant U.S. tax cost, assuming subpart F does not apply.

The proposed GILTI regulations classify these transactions as *per se* abusive — even if undertaken for a good business purpose:

> The Treasury Department and the IRS have determined that it would be inappropriate for a taxpayer to reduce its GILTI inclusion for any taxable year by reason of a stepped-up basis in CFC assets attributable to transactions between related CFCs during the period after December 31, 2017, but before the effective date of section 951A. Accordingly, the proposed regulations disallow a benefit of a stepped up basis in specified tangible property transferred between related CFCs during the period before the transferor CFC's first inclusion year for purposes of calculating the transferee CFC's QBAI.[14]

Could this regulation be challenged as *ultra vires*? It certainly would require exceptional facts, of the type that would succeed if the Treasury had adopted a rebuttable presumption rather than a *per se* rule. The GILTI paragraph defining QBAI provides broad anti-abuse authority to Treasury:

> (4) Regulations. The Secretary shall issue such regulations or other guidance as the Secretary determines appropriate to prevent the avoidance of the purposes of this subsection, including regulations or other guidance which provide for the treatment of property if—
> (A) such property is transferred, or held, temporarily, or
> (B) the avoidance of the purposes of this paragraph is a factor in the transfer or holding of such property.[15]

This grant of regulatory authority requires that the QBAI be held temporarily or have an avoidance purpose. Since this strategy was publicly identified early

[11] Prop. Reg. §1.951-1(e).

[12] Prop. Reg. §1.951-1(d)(3)(ii).

[13] Prop. Reg. §1.951-1(e)(6).

[14] 83 Fed. Reg. 51,072 at 51,077.

[15] §951A(d)(4).

ISSN 0090-4600

on, proving that avoidance was not even a ''factor'' would be difficult. If there were an ideal test case, it might involve QBAI transferred to a loss CFC in a divestiture forced by a foreign regulator.

Undoubtedly, there are end-arounds that taxpayers might consider, but the donut hole taxpayer — i.e., one that tries to increase QBAI during the period between the last date relevant for §965 and the first date to which §951A applies, by arranging a transfer between related CFCs — may not present a sympathetic case. The IRS and Treasury have made clear that not much leeway will be available for these transactions.

SCHEDULE OF RELEASE FOR OTHER 2017 TAX ACT REGULATIONS

We understand that Treasury will issue four more sets of proposed regulations, totaling more than 1,000 pages, by the end of 2018. Those regulations will cover the tough new interest-expense limitation rules under §163(j), foreign tax credit issues, including those relating to GILTI, the Base Erosion and Anti-Abuse Tax, and the new anti-hybrid provisions under §267A.

Another three sets of proposed regulations are expected in early 2019. They will address foreign derived intangible income, the participation exemption under §245A, and accounting for previously taxed income.

Treasury's stated goal for all of these regulations is to go final by June 22, 2019, to ensure the regulations apply retroactively to the relevant effective dates.

CONCLUSION

The above aspects of the GILTI regulations may produce harsh consequences for taxpayers. As more proposed regulations are issued, taxpayers may need to assess whether there are opportunities for challenge and whether they have cost-effective structuring solutions. The drafters focused on consistency with the overall statutory framework, while protecting the U.S. fisc. There clearly are, however, opportunities for planning, particularly with respect to QBAI stranded in a loss CFC.

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