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'IP Come home!' How TCJA Incentivizes Asset Repatriation

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Much has been written about how the recent Tax Cuts and Jobs Act, P.L. 115-97,[1] is incenting U.S. multinational companies to bring jobs and income home. However, there are two lesser-known related provisions of TCJA specifically targeting more "portable" income. This is income from assets that are easily moved to other countries, such as intellectual property, or IP.[2]

The two provisions — global intangible low-taxed income, or GILTI,[3] and foreign-derived intangible income, or FDII[4] — share a common goal: keeping U.S. companies' intangible assets home in the U.S. instead of wandering the globe in search of shelter offshore in no-tax or low-tax countries. GILTI is generally bad news for affected taxpayers and FDII is generally good news.

GILTI— Intangibles Income of Controlled Foreign Corporations

GILTI aims to stop U.S. businesses from transferring mobile assets such as IP out of the U.S. to related foreign corporations located in tax haven type countries. It does so by requiring the payment of a minimum global tax on income generated from these assets.

The tax is based on a controlled foreign corporation's, or CFC's, net income less a 10 percent deemed return on the CFC's qualified business asset investment, or QBAI — which is roughly a deemed return on the CFC's depreciable tangible property.[5][6]

Any GILTI tax is then imposed pro rata on affected persons. The persons affected will generally be the CFC's U.S. shareholders as of the last day of the CFC's taxable year in which the GILTI is included in the gross income of the CFC.[7]

Important: GILTI tax applies regardless of whether the GILTI is repatriated to the U.S. or not and, as noted above, is imposed on the U.S. shareholders of the CFC.

Note: However, as will be explained, if "enough" foreign tax is paid by the CFC on the GILTI there will be no GILTI tax on at least the CFC's C corporation U.S. shareholders.

Further Note: For non-C corporation U.S. shareholders getting to "enough" would appear to be considerably more difficult.

What GILTI Can Cost — At Least for C Corporation U.S. Shareholders

For CFC tax years after Dec. 31, 2017, and before Jan. 1, 2026,[8] the minimum effective GILTI tax rate for affected C corporation U.S. shareholders will be 10.5 percent. The rate climbs to 13.125 percent for CFC tax years beginning after Dec. 31, 2025. Why the bump up? It is because GILTI deductions will decrease from a 50 percent GILTI deduction for CFC tax years after Dec. 31, 2017, and before Jan. 1, 2026, to a 37.5 percent GILTI deduction for such tax years beginning after Dec. 31, 2025.

Important: The GILTI rules do not always result in a GILTI tax being due to the U.S. even where there is GILTI. As set forth in the Joint Explanatory Statement of the Committee of Conference accompanying the text of TCJA:

"[For taxable years of CFCs after December 31, 2017, and before January 1, 2026,] … since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a <u>domestic corporation</u>[emphasis added] is 13.125 percent.[9] If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 10.5 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125%, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5% and 13.125% At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

"For <u>domestic corporations</u>[emphasis added] in taxable years beginning after December 31, 2025, the…effective U.S. tax rate on GILTI is 13.125 percent. The minimum foreign tax rate, with respect to GILTI, at which [point] no U.S. residual tax is owed is 16.406 percent."[10]

So, for example, assume:

(i) a tax year of a CFC, "Subco," located in country X after Dec. 31, 2017, and before Jan. 1, 2026,
(ii) that Subco is at all relevant times 100 percent owned by "ParentCo,"a C Corporation

U.S. shareholder of SubCo, and
(iii) that Subco pays no tax (0 percent) tax to X.

On those facts, ParentCo would pay a tax to the U.S. of 10.5 percent on ParentCo's 100 percent share of GILTI, resulting in a total effective tax rate of 10.5 percent.

Now, assume the same facts, except that SubCo is located in a 12.5 percent tax country, Y. In this case, SubCo pays a 12.5 percent tax to country Y and ParentCo pays a residual U.S. GILTI tax to the U.S. of .5 percent, resulting in a total effective tax rate of 13 percent.

Finally, if SubCo were to be located in a 13.125 percent tax country, Z, Subco would pay tax at a 13.125 percent to rate to Z and ParentCo would not pay any residual tax to the U.S. on its share of GILTI, resulting in a total effective tax rate of 13.125 percent.[11]

These sorts of effective tax rates might still sound good for C corporation U.S. shareholder taxpayers compared to the 21 percent general U.S. corporate rate applicable under TCJA.[12] But many corporations under pre-TCJA law were able through their CFCs to pay no, or much lower, foreign tax rates than 13.125 percent on such income. Moreover, they could often indefinitely defer their U.S. corporate tax on this income.[13] What this means is that under GILTI, the days of no or ultra-low global taxation for intangibles leaving the U.S. to be housed in CFCs are at an end.

More GILTI Bad News — Especially for Non-C Corporation U.S. Shareholders

Following a new one-time transition tax under TCJA,[14] dividend distributions out of certain CFC foreign profits may now escape U.S. taxation in the hands of U.S. shareholders who are C corporations under TCJA's participation exemption.[15] But not so for cases of GILTI where, as in some of the previous examples, the GILTI is earned in a no-tax or low-tax foreign jurisdiction. In these instances, a full or residual tax on the GILTI is owed to the U.S. What this means is that a complete escape from paying residual U.S. tax on GILTI comes at the cost of paying foreign tax on GILTI at a rate that is not as great a bargain as in the past.

Worse yet (perhaps even much worse), the rate of effective tax on GILTI can increase to (i) up to 37 percent plus (ii) any foreign tax on GILTI income for affected non-C corporation U.S. shareholders. This is because non-C corporation U.S. shareholders: (i) will typically be subject to much higher U.S. tax rates on their taxable income than C corporation U.S. shareholders, (ii) will not receive a deduction for GILTI,[16] and (iii) may not be able take any foreign tax credit against GILTI.

Under prior law, affected non-C corporation U.S. shareholders of CFCs with GILTI generally would have paid no current tax on what is now considered GILTI. If they did pay tax, it would likely have been at U.S. tax rates as low as 20 percent on repatriation if the GILTI was ever repatriated. As outlined above, now, under TCJA, affected non-C corporation U.S. shareholders may pay U.S. taxes of up to 37 percent on their share of GILTI, plus bear the full economic effect of the applicable foreign tax on that share, regardless of whether GILTI is currently distributed to them or not. However, certain planning techniques may be available to mitigate this result. For example, interpositioning a "blocker" C corporation to hold the shares of non-C U.S. shareholders in the CFC generating the GILTI. Some have suggested a so-called IRC 962 election could qualify electing non-C U.S. shareholders for the lower corporate rate and the foreign tax credit available to C corporation U.S. shareholders.

FDII — Intangibles Income of U.S. Corporations Earned Abroad

Broadly defined, FDII is all of a U.S. corporation's income generated from property sold, leased or licensed by a U.S. corporation to any person who is not a U.S. person, reduced by a deemed 10 percent return on the QBAI of the U.S. corporation(this QBAI is calculated in a fashion akin to the QBAI referred to above in the discussion of GILTI). Among the exceptions to qualifying for FDII treatment that apply are transactions with related persons or where U.S. intermediaries are involved. Also, FDII does not apply to S corporations, regulated investment companies, or RICs, or real estate investment trusts, or REITs.[17]

Qualifying for FDII treatment will generally be a goal for many U.S. corporate taxpayers. Instead of the basic 21 percent U.S. corporate tax rate under TCJA, these provisions tax the FDII income of U.S. C corporate taxpayers at an effective rate of 13.125 percent for tax years after Dec. 31, 2017, and before Jan. 1, 2026. Then the tax rate on FDII increases to 16.406 percent for tax years beginning after Dec. 31, 2025.

From a U.S. tax collection and jobs creation point of view, FDII incentivizes U.S. companies to keep their IP owned onshore (i.e., in the U.S.) and then export it for sale abroad.

FDII is generally perceived to be very good news for U.S. C corporations exporting "made in the U.S.A." IP-type goods and services to foreign markets. As noted, it lowers the U.S. tax rate for FDII from 21 percent to 13.125 percent through 2025 and then (despite a small bump up) to a still favorable 16.406 percent in 2026 and after. The rate bump up is due to the decreased deduction for FDII from an initial 37.5 percent of FDII to 21.875 percent of FDII after 2025.

However, response to FDII from abroad, particularly from the European Union, has been less than enthusiastic. The feedback is that FDII amounts to an illegal export incentive in violation of WTO rules. [18] The U.S. has reportedly issued a preliminary official response to the complaints. But the reaction to the FDII from abroad does create some uncertainty for U.S. persons trying to plan to use FDII.

GILTI and FDII in the Real World

With some exceptions, GILTI and FDII mechanically treat income in excess of the 10 percent deemed return of QBAI (again, that portion of income roughly exceeding the deemed return from tangible depreciable assets) as subject to the tax.

For example, the GILTI of a CFC with $1,000,000 of QBAI would generally be its income in excess of a $100,000 ceiling. The same principle applies to FDII. A U.S. C corporation with $1,000,000 of QBAI would generally have deemed intangible income on income in excess of the $100,000 ceiling.

The nature of the income exceeding the ceiling is irrelevant to its categorization as GILTI or FDII. So, this formulistic approach could well pull into the GILTI/FDII tax net, for good or ill, income items which are not intangible property. Thus, strictly speaking, neither GILTI nor FDII is a patent box regime or even an intangible property tax regime. Additionally, owing to this mechanical QBAI allocation method, GILTI may pull in income which is not really that low-taxed.

FDII applies only to U.S. C corporations. By contrast, GILTI applies to non-C corporation U.S. shareholders and C corporation U.S. shareholders.

GILTI and FDII have spawned a new cottage-industry subset of the tax planning industry to address the issues they raise. The new industry is focused on how to plan for the potential exposures or benefits of, and to restructure businesses, supply chains, and financing to deal effectively with, GILTI and to take advantage of FDII. With FDII, for example, it can be expected that U.S. companies will consider leaving IP onshore, and will also evaluate how much of their export income can be put into the “intangibles” bucket. With GILTI, planners will be looking at ways to lessen the burden of GILTI especially on non-C corporation affected U.S. shareholders. And, of course, with GILTI the opposite of FDII applies, which for GILTI planning is to beef up tangibles, in order to decrease the “intangibles” bucket subject to GILTI.

Although GILTI and FDII encourage keeping IP type assets at home in the U.S., there may still be considerable offshoring resulting from lower labor costs, or even talent pools, abroad that may not be available in the U.S.. In turn, these sorts of non-tax, economic considerations can be expected to continue to raise transfer pricing issues on cross-border related company transactions.[19]

It is not clear to what extent GILTI and/or FDII will be applied under U.S. state and local income tax laws. Generally, state and local income taxes tend to use federal tax laws as a starting point for the computation of taxable income but there certainly can be differences. Given the possible differences, there may be state and local tax benefits to some businesses from moving, within U.S., the place where they are doing business.

This is not an exhaustive treatment of, and surely not the final chapter on, GILTI and FDII. All manner of administrative regulations, rulings, notices, technical corrections, etc. on GILTI and FDII, as well as the myriad other provisions of TCJA, can be anticipated. Be prepared.

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[1] Not technically the correct name, due to last minute skirmishing in the U.S. Congress, but commonly used nonetheless.
[2] More specifically, but not exhaustively, IP can be thought of as items such as inventions, literary and artistic works, computer software and hardware, designs, symbols, names and images used in commerce, and know-how. Much of IP can be legally protected by, for example, patents, copyrights and trademarks laws.
[3] IRC 250 and IRC 951A.
[4] IRC 250.
[5] Under IRC 957(a) a CFC is generally any foreign corporation if more than 50 percent of:

- the total combined voting power of all classes of stock of such corporation entitled to vote, or
- the total value of the stock of such corporation, is owned, or is considered as owned by applying certain constructive ownership rules, by United States shareholders on any day during the taxable year of such foreign corporation.

  Under IRC 951 (b) a "United States shareholder" generally means, with respect to any foreign corporation, a United States person who owns, or is considered as owning by applying certain constructive ownership rules, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

Under IRC 7701 (a)(30) the term "United States person" means —

(A) a citizen or resident of the United States,

(B) a domestic partnership,

(C) a domestic corporation,

(D) any estate (other than a foreign estate), and

(E) any trust if —

(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more United States persons have the authority to control all substantial decisions of the trust

This definition of "United States person" has, for purposes of CFC, some limited exceptions set forth in IRC 957(c) dealing with income situations arising for corporations organized in Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands ("957(c) territories") and applicable, in each case, to except certain individuals resident in an applicable 957(c) territory from treatment as United States persons

[6] Technically GILTI = Net CFC Tested Income - (10% * QBAI) — Certain Allocated Interest Expense

Net CFC Tested Income excludes effectively connected income, or ECI (ECI is income effectively connected to the conduct of a U.S. trade or business), Subpart F income, related party dividends, certain high taxed income, and some other income.

QBAI is based on the average of the aggregate of the CFC's adjusted basis in specified property used in its trade or business of a type which is generally depreciable under IRC 167. This would include, for example, tangible assets used in the CFC's business such as furniture, tools, machinery and equipment.

Once GILTI is calculated for affected C corporation U.S. shareholders, then 50 percent (going down to 37.5 percent after 2025) of GILTI may be deducted and a credit of 80 percent of any applicable foreign tax credit is allowed to arrive at the actual GILTI tax. Affected non-C corporation U.S. shareholders do not get the 50 percent deduction nor automatically qualify to use the foreign tax credit.

[7] Some fairly exotic timing issues as to when GILTI is taxed can be involved. Also, there can be anomalies in results where there is a change in ownership of the CFC generating GILTI during the CFC's taxable year. Commentators have suggested technical corrections will be needed to deal with some of these issues.

[8] The GILTI gets included in income as to U.S. shareholders in those tax years of the U.S. shareholders in which or with which such tax years of their related CFC's end.

[9] For these years, 13.125 percent equals the effective GILTI rate of 10.5 percent divided by 80 percent. If the foreign tax rate on GILTI is 13.125 percent, and domestic corporations are allowed a credit equal to 80 percent of foreign taxes paid, then the post-credit foreign tax rate on GILTI equals 10.5 percent (=

13.125% × 80%), which equals the effective GILTI rate of 10.5 percent. Therefore, no U.S. residual tax is owed.

[10] For these years, if the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 13.125 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 16.406 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 13.125 percent and 16.406 percent. At foreign tax rates greater than or equal to 16.406 percent, there is no residual U.S. tax on GILTI and the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

[11] These rates would all go up in a hypothetical on the same facts with one change: that the tax year in question of Subco began after December 31, 2025.

[12] IRC 11(b).

[13] It was often possible to structure this income as non-Subpart F income, and hence defer U.S. taxation, by making it "active" income or finding an applicable exception to Subpart F.

[14] IRC 965.

[15] See IRC 245A for full details of the participation exemption.

[16] IRC 250(a)(1).

[17] Technical calculation of FDII:

Preliminarily:

1. Figure *deduction eligible income*. The U.S. corporation's gross income is calculated and then decreased by certain items of income, including amounts included in income under Subpart F, CFC dividends to a 10% US Shareholder, and income earned in foreign branches. This amount is then further decreased by deductions associated with such income (which includes taxes) resulting in *deduction eligible income*.
2. Figure foreign-derived deductible eligible income. This generally entails income from the sale of property to any foreign person for a foreign use. The term "sale" encompasses any lease, license, exchange or other disposition. "Foreign use encompasses "any use, consumption, or disposition which is not within the United States." Qualifying foreign income also includes income from services provided to any person not situated within the United States, or from property that is not situated in the United States. The services may be performed within or outside the United State. Exceptions apply for transactions with related parties or where U.S. intermediaries are involved. The gross foreign sales and services income is decreased by expenses associated with such income. The sum of these two (sales + services) amounts equals foreign-derived deductible eligible income.

3. Figure *deemed intangible income*. This is the excess (if any) of the corporation's deduction eligible income over 10 percent of its QBAI which is expressed as:

Deemed Intangible Income = Deduction Eligible Income – (10% *QBAI)

Finally, figure FDII as follows:

FDII = Deemed Intangible Income * (Foreign-Derived Deduction Eligible Income/Deduction Eligible Income).
Currently a U.S. C corporation is allowed deduction of 37.5% of its FDII (going down to 21.875% after 2025)

[18] For example, some experts feel that if a U.S. sales or income tax is reduced on condition of the exportation of the goods or intangibles concerned, it would be a subsidy “contingent upon export performance” prohibited by the WTO.
[19] For example, TCJA’s BEAT (base erosion anti-abuse tax) provisions raise new transfer pricing issues for larger multinationals who engage in transactions with related parties. See IRC 59A.