US tax reform series - presumed GILTI (the 'stick')

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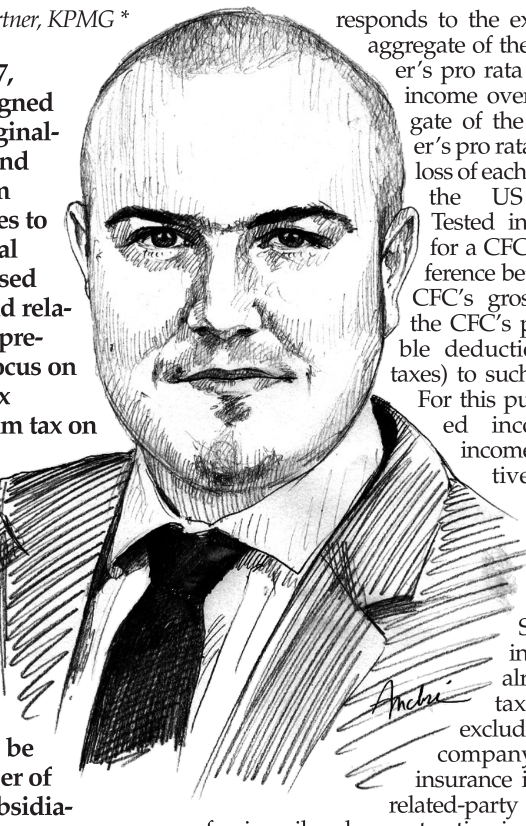

On 22 December 2017, President Trump signed into law H.R. 1, originally known as the Tax Cuts and Jobs Act. The US tax reform makes fundamental changes to the taxation of multinational entities. As we have discussed the deemed repatriation and related one-time transition tax previously, in this article we focus on another aspect of the US tax reform — the new minimum tax on global intangible low-taxed income (GILTI). GILTI is also nicknamed the 'stick' by opposition to the 'carrot', namely the foreign derived intangible income (FDII) regime[1]. The impact of GILTI on Luxembourg is expected to be significant as a large number of US multinationals have subsidiaries in the country.

Background

Generally speaking, GILTI is aimed at discouraging erosion of the US tax base by moving or retaining valuable intangibles outside of the US tax net and bringing their related income back to the US tax-free. The objective of GILTI is thus to deter US corporations from transferring intangible property to low-tax jurisdictions by subjecting the income to the current US taxation.

Importantly, however, GILTI will not only be limited to earnings on intangible assets but will also impose the current US tax on certain higher-than-routine returns on assets that are earned in low-tax jurisdictions. While labeled a tax on intangible income, the GILTI tax is actually a current tax imposed on US shareholders of controlling foreign companies (CFCs)[2] on their share of any income earned by these companies that exceeds a 10% return on investment[3].

The effect of GILTI is to subject US shareholders of CFCs to current taxation on the aggregate net income of their CFCs over a routine return. In practice, this means that no actual distribution from the CFC to its US parent company is needed to make GILTI income picked up and taxed at the level of the US parent company. Hence, GILTI is an important exception to the territoriality approach that the US tax reform has been presented as pursuing.

The GILTI regime is effective for tax years beginning after 31 December 2017.

GILTI inclusion calculation

As we shall see, the calculation of GILTI inclusion and the corresponding federal tax is complicated. GILTI generally impacts US shareholders of CFCs that have significant intangible assets compared to fixed/tangible assets (or high income relative to low depreciable assets).

The GILTI amount is determined by first calculating a deemed return on the CFC's tangible assets (net deemed tangible income return). The portion of the CFC's tested income that exceeds the deemed return on tangible assets is then included in the US shareholder's GILTI amount.

> **GILTI income** = Net CFC tested income – Net deemed tangible income
> or
> **GILTI income** = Net CFC tested income – [(10% * QBAI) – Interest expense]

Where:
- **Net CFC tested income** means the US shareholder's aggregate pro rata share of excess of tested income over tested loss for a given CFC. It corresponds to the excess of (1) the aggregate of the US shareholder's pro rata share of tested income over (2) the aggregate of the US shareholder's pro rata share of tested loss of each CFC owned by the US shareholder. Tested income (or loss) for a CFC equals the difference between all of the CFC's gross income and the CFC's properly allocable deductions (including taxes) to such gross income. For this purpose, the tested income excludes income that is effectively connected with a US trade or business (which is already generally taxable), Subpart F gross income (which is already generally taxable), certain excluded foreign base company income or insurance income, foreign related-party dividends, and foreign oil and gas extraction income.
- **Net deemed tangible income** means 10% of the shareholder's aggregate pro rata share of the qualified business asset investment (QBAI) of each CFC, less the amount of interest expense taken into consideration of the CFC tested income[4]. In this context, QBAI means the average of the adjusted bases in specified tangible and depreciable property used in its trade or business determined on a quarterly basis of the taxable year. The adjusted basis is determined using an alternative depreciation system and allocating the depreciation deduction ratably to each day during the period. Thus, QBAI appears to be essentially a book value concept based on the tax basis of the CFC's assets and not their fair market value.

US shareholders owning less than 100% of a CFC will include only their pro rata shares of the CFC's net deemed tangible income return and tested income in calculating the GILTI amount. Furthermore, US shareholders owning an interest in more than one CFC must aggregate the net deemed tangible income return and tested income of each CFC. The GILTI amount is then included in the taxpayer's gross income for the taxable year, regardless of whether distributions were received from the CFC.

Because the GILTI regime imposes income inclusion reduced for a deemed 10% return of a CFC's tangible depreciable assets, a business with minimal tangible assets (such as a holding or financing company or more importantly some High-tech companies and most of the GAFA's) will have a significantly higher percentage of income subject to the inclusion than a business that relies heavily on such assets.

CFCs operating in jurisdictions that provide tax incentives (such as tax holidays or enterprise zone tax benefits) will find that the income earned in such jurisdictions is vulnerable to the GILTI inclusion. In case of CFCs located in onshore jurisdictions such as Luxembourg, the GILTI regime is just another strong incentive (in addition to OECD- and EU-related tax measures related to the Base Erosion and Profit Shifting (BEPS) action plan at its EU transposition in the ATAD) to grow the economic substance at the CFC level.

GILTI rate and FTC

US shareholders that are C corporations (i.e., companies subject to regular corporation tax in the US) are given special tax benefits, which can eliminate the GILTI tax.

The first advantage C corporations have over other US shareholders when applying GILTI regime concerns the effective GILTI rate. As per the new Internal Revenue Code (IRC) Section 951A, a US shareholder of CFC must include on a current basis the GILTI income. For US shareholders that are C corporations, GILTI however has been provided with a 50% deduction, resulting in an effective rate on GILTI of 10.5% (50% of the new reduced US corporate income tax rate of 21%). The effective GILTI rate for C corporations will increase to 13.125% in 2026.

The second, advantage for C corporations concerns the deemed foreign tax credit (FTC) allowed by GILTI. For any amount of GILTI included in the gross income of a C corporation, such C corporation would be deemed to have paid foreign income taxes equal to 80% of the foreign taxes paid by the CFC with respect to such income. However, on top of such FTC being limited to 80%, there is a separate GILTI basket with no FTC carryforward or carryback allowed, meaning foreign taxes paid on income in other categories cannot be aggregated with GILTI and its corresponding FTCs. Prior to 2026, the minimum foreign tax that will result in no inclusion of income under GILTI (for a C corporation) after application of the 80% FTC is thus 13.125% (i.e., 10.5 / 80%). As from 2026 onwards, it will increase to 16.406% (i.e., 13.125 / 80%).

The following are the key takeaways:
- In essence, until 2026, if a US C corporation has CFCs that pay taxes in a foreign jurisdiction at a rate of at least 13.125% (20% more than the US rate charged on GILTI of 10.5%), then the FTC allowed against GILTI should theoretically eliminate the corporation's US tax liability. However, this is not always the case. For example, if a C corporation has interest expense at the US level, it may allocate and apportion some of that amount in such a way as to reduce the entity's foreign tax credit, and subsequently leave the entity with some additional US tax liability.
- US shareholders that are not C corporations do not benefit from the 50% deduction and the deemed 80% FTC. Individuals and S corporations get no similar treatment and pay full US tax on any GILTI inclusion amount. There is therefore an incentive in the H.R. 1 for individual taxpayers to prefer investments via C corporations over investments via S corporations and direct holding. US taxpayers should carefully review the structure of their foreign entities with their advisors to determine if the new regime may apply to them, and whether any foreign corporations may qualify as CFCs, which will subject their US shareholders to the new GILTI tax.
- Irrespective of the circumstances, taxpayers with offshore earnings should engage in careful review of their structure under the guidance of experienced international tax advisors[5]. Under some circumstances and depending on how the Internal Revenue Service will address the new tax law's exclusion of high-taxed and/or Subpart F income, it may behoove taxpayers to restructure their international operations to minimize feeling GILTI in the future.

Potential impact on Luxembourg

The US tax reform will have an impact on tax regimes around the world. However, the way in which any particular country will respond to this reform is likely to depend on a number of factors. Three seem particularly relevant in the case of Luxembourg.

To what extent does the tax regime in question have a corporate tax rate that now looks high by comparison to the new US federal tax rate which has been reduced down to 21% by the H.R. 1?

Prior to the US tax reform, corporate tax rates in the mid to high 20s did not look completely out of kilter, given that the world's largest economy had a 35% tax rate. Now, suddenly, those economies appear exposed. Countries such as the UK, which has gradually reduced its corporation tax rate from 28% to 19% since 2010, and which is expected to reduce the rate to 17% by 2020, look less remarkable than they did in the past. In all likelihood, to remain competitive in a post-BEPS environment, OECD and EU economies, including Luxembourg, will face some downward pressure on corporate tax rates. As recently mentioned by the Luxembourg Bankers' Association, a tax rate of 21%, which is not only the new US federal corporate tax rate but also the average rate in the EU, could appear as a 'maximum admissible' going forward[6]. Compared to one of the most competitive corporate tax rate in the EU (12.5% in Ireland), the 21% rate may however still be too high, and a lower rate ranging between 15% and 17% would clearly reduce the gap with Ireland in an acceptable way.

To what extent do US businesses respond to the US tax reform, particularly GILTI and FDII, by bringing back to or creating new jobs and functions in the US rather than in other jurisdiction?

It is not clear whether they will. One may recall that the introduction of a territorial system has tended to result in offshoring in other jurisdictions that have done so. Furthermore, some features of GILTI, in particular, may incentivize US businesses to transfer more tangibles outside the US. If a significant number of businesses moves a significant number of jobs and/or functions to the US, other jurisdictions may create a number of targeted incentives, such as R&D credits and patent boxes, to discourage such repatriation. In this respect, it is interesting to note that Luxembourg is already well equipped with the investment tax credit increased last year, the recently enacted new BEPS-compliant IP regime of article 50ter of the Luxembourg income tax law, and the public subsidies promoting R&D and innovation in the Grand-Duchy. On the contrary, if a jurisdiction considers that the battle has been lost, it may seek to impose a significant repatriation tax in response.

To what extent does US tax reform provide an opportunity to jurisdictions to adapt their tax systems to provide a symbiotic relationship with the US tax regime?

Many jurisdictions — especially those with tax haven characteristics — are concerned about the impact of BEPS and are looking for a role in the international tax space. The complexity of the US tax reform could provide opportunities to jurisdictions looking to make themselves attractive from a tax point of view to US businesses. Business-friendly onshore jurisdictions such as Luxembourg, which regularly compete with certain of these offshore jurisdictions for certain markets or types of activities, will have to closely monitor their reaction to the US tax reform with the view of maintaining a level playing field.

As mentioned in a recently published article[7], "Only time will tell whether the US tax reform of 2017 will result in the desired effect of stimulating the US economy and it will also take time to see all the impacts it may have on the rest of the world. While we wait, companies will continue to identify ways to maximize their returns in this new environment, and policymakers outside the US will consider their responses."

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1) Though FDII is generally presented as an incentive to locate intangible assets in the US, FDII is a category of income that is not specifically traced to intangible assets. Rather H.R. 1 assumes a fixed rate of return on business assets and the residual income is the income deemed to be generated by IP. FDII earned by US C corporations in the US are taxed at the beneficial rate of 13.125%.
2) A CFC is defined as any foreign corporation if US shareholders own more than 50% of its stock; for this purpose, a US shareholder is any US person who owns 10% or more of the voting stock or value of the stock of the foreign corporation.
3) In the context of the transposition of the Anti-Tax Avoidance Directive, 13 EU Member States, among which Luxembourg, that do not have CFC rules yet, will adopt some CFC rules applicable as from a 1st January 2019. Due to the existence of two different alternatives available to such Member States when transposing the CFC rules embedded in the ATAD, as well as the particularities of the CFC regimes that some other Member States have implemented before the ATAD, the question of the CFC rules should be particularly complex within the EU going forward.
4) It will be interesting to see how this rule will interact with the future European mandatory disclosure rules that will impose on intermediaries to report certain arrangements, including those where deductions for the same depreciation on an asset are claimed in more than one jurisdiction.
5) When applicable, the GILTI inclusion will increase the tax liability of CFCs subject to taxation in their jurisdiction of residence at a rate that is lower than 13.125% to cap it at 13.125%. However, this fact shall not be misinterpreted. Such CFCs remain obviously more attractive than CFCs that are taxed locally at a rate that is greater than 13.125%. As a result, the adverse effect of GILTI on CFCs that subject to taxation at a rate lower than 13.125% locally must be put into perspective. This also means that the EU and international tax competition to attract US investors will continue, in particular via the reduction of corporate tax rates should continue.
6) ABBL, Elections législatives 2018 - Réflexions et priorités de l'ABBL à l'attention des partis politiques.
7) Linda Pfatteicher, Jeremy Cape, Mitch Thompson and Matthew Cutts, GILTI and FDII: Encouraging U.S. Ownership of Intangibles and Protecting the U.S. Tax Base, Bloomberg BNA, 02/27/2018.