INSIGHT: Fundamentals of Tax Reform: GILTI

BY BARBARA RASCH AND JOSHUA KAPLAN

In the third of a four-part series on the fundamentals of tax reform, Barbara Rasch and Joshua Kaplan of KPMG LLP provide a general overview of the global intangible low-taxed income (GILTI) rules in new tax code Section 951A. They explain the issues involved in computing the GILTI inclusion, taking into account the guidance provided in the recently issued GILTI proposed regulations. As with the other articles in this “Fundamentals of Tax Reform” series, the article is intended to provide practitioners who do not regularly work in the international tax area with a high level understanding of the purpose and basic operation of the new GILTI rules, a sense of sticking points that may merit more careful consideration, and a few “practical notes” that provide useful insight on the application of the rules.

Introduction

GILTI, or the global intangible low-taxed income provision added by Pub. L. 115-97 (TCJA or tax reform) significantly broadens the scope of foreign earnings that, prior to tax reform, had been subject to current U.S. taxation. The GILTI regime effectively imposes a worldwide minimum tax on foreign earnings and subjects U.S. shareholders of controlled foreign corporations (CFCs) to current taxation on most income earned through a CFC in excess of a 10 percent return on certain of the CFC’s tangible assets (subject to a reduction for certain interest expense).

The GILTI regime was intended to deter taxpayers from locating high-value activities and assets in low-tax jurisdictions. Despite the provision’s name—and not unlike the foreign-derived intangible income or “FDII” rules—the GILTI rules are not directly linked to a CFC’s intellectual property. In the case of GILTI, the rules reach almost all income earned by a CFC that isn’t otherwise subject to U.S. tax, regardless of whether the income is derived from intangibles or is subject to a low foreign tax rate. To somewhat soften the blow of the new regime, GILTI inclusions received by corporate taxpayers can be taxed at a preferential rate of 10.50 percent (achieved through a deduction in new Section 250) through 2025. Tax reform also added a new participation exemption system (new Section 245A), which provides a 100 percent dividends received deduction (DRD) for certain dividends paid by a foreign corporation to a U.S. corporate shareholder. The DRD is limited, however, to CFC earnings that are not subject to tax under the GILTI rules or existing anti-deferral regimes. The GILTI rate increases to 13.125 percent beginning in 2026, as a result of a decrease in the Section 250 deduction rate.

The Department of the Treasury and Internal Revenue Service (IRS) published proposed regulations on Oct. 10, 2018 (which were advance released on Sept. 13, 2018) that contain proposed rules to implement the GILTI provision (the “proposed regulations”). The proposed regulations focus on the computational elements of the GILTI inclusion and include a number of new defined terms that feed into the computation.

Practical Notes: While the proposed regulations provide helpful guidance, the regulations leave open a number of critical questions that taxpayers have been facing since tax reform was enacted. This includes issues involving the interaction of the GILTI rules with other provisions, e.g., the GILTI deduction in Section 250, foreign tax credits, the new Section 163(j) interest limitation rule, the new hybrid instrument rules under...
Overview

Prior to tax reform, U.S. shareholders generally were not subject to U.S. tax on income earned by foreign subsidiaries until the income was distributed as a dividend, unless the income was subject to the Subpart F regime or another anti-deferral regime (e.g., Section 956 or the passive foreign investment company regime), in which case the income was subject to tax on a current basis. Tax reform was billed as a shift towards a territorial tax system, with the introduction of the new DRD, but despite this permanent exemption from U.S. tax for qualifying dividends, tax reform in reality moved the United States closer to a full worldwide tax system.

Tax reform generally retained—and in some cases expanded—the traditional Subpart F, passive foreign investment company, and Section 956 anti-deferral rules. In addition, tax reform doubled down on anti-deferral with the introduction of the GILTI regime, which effectively functions like a “super Subpart F” regime and sweeps in most foreign subsidiary income not caught by the existing anti-deferral rules. The amount of a taxpayer’s potential GILTI inclusion is reduced, however, by an artificial deemed return on certain of its CFCs’ tangible assets, generally equal to 10 percent of the CFC’s basis in tangible depreciable assets that give rise to GILTI “tested income” (referred to as “qualified business asset investment” or “QBAI”), which itself is subject to reduction based on its CFCs’ interest expense. The excess of the 10 percent return over the interest expense generally is eligible for the DRD, along with the small sliver of other income that makes it past the GILTI, Subpart F, and other anti-deferral regimes.

The GILTI rules generally apply to U.S. persons that own more than 10 percent of the vote or value of a CFC (U.S. shareholders), which generally is a foreign corporation that is more than 50 percent owned by U.S. shareholders (also by vote or value). Under the Subpart F rules that govern the CFC regime, U.S. shareholders historically have been required to include amounts in income based on the Subpart F income earned by their CFCs (Subpart F inclusions), regardless of whether that income is currently distributed. The GILTI rules require U.S. shareholders to include an amount in income annually based in part on the “tested income” and “tested loss” earned by their CFCs (GILTI inclusion). The GILTI inclusion rules, which are largely formulaic, are applicable for tax years of a CFC that begin after Dec. 31, 2017.

Calculating GILTI

A. General Rules

\[ \text{GILTI} = \text{Net CFC Tested Income} - \text{DTIR} \]

Using the new GILTI vocabulary, a U.S. shareholder’s GILTI inclusion equals the excess (if any) of the U.S. shareholder’s “net CFC tested income” over its “net deemed tangible income return” or “DTIR.” At a very high level, for corporate shareholders this has the effect of dividing a CFC’s income into three buckets: (i) income subject to current taxation or special tax rules (at 21 percent or other relatively high rate); (ii) a deemed 10 percent return on certain tangible assets (which, minus certain interest expense, is eligible for the DRD); and (iii) income subject to current taxation at a reduced, GILTI rate of tax. A U.S. shareholder for this purpose generally is a U.S. person that directly, indirectly, or constructively owns 10 percent of the voting power or value of the CFC on any day during the year, and who directly or indirectly owns any amount of CFC stock on the last day of the CFC’s taxable year on which it is a CFC.

The GILTI rules are effective for tax years of foreign corporations beginning after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end. For calendar year CFCs and U.S. shareholders, GILTI kicked in on Jan. 1, 2018. For CFCs with Nov. 30 year ends, GILTI will not go into effect until their taxable years beginning Dec. 1, 2018. Calendar year shareholders of Nov. 30 CFCs therefore would not have a GILTI inclusion with respect to those CFCs until 2019.

Practical Notes: Tax reform expanded the U.S. shareholder definition to be based on either voting power or value, rather than solely on voting power. In addition, prior to tax reform, Section 958(b)(4) prevented “downward attribution” of foreign stock from a foreign entity to a U.S. person for Subpart F purposes. Tax reform repealed this rule, resulting in many more foreign corporations qualifying as CFCs and investors as U.S. shareholders. Nevertheless, while CFC or U.S. shareholder status may result in new filing obligations for U.S. shareholders of Nov. 30 CFCs therefore would not have a GILTI inclusion with respect to those CFCs until 2019. Shareholders of Nov. 30 CFCs therefore would not have a Subpart F or GILTI inclusion with respect to a CFC unless the U.S. shareholders treated as directly or indirectly owns stock in the CFC on the last day of the CFC’s year in which it is a CFC.

B. Calculating Net CFC Tested Income

\[
\text{Net CFC Tested Income} = \text{U.S. Shareholder’s Aggregate Tested Income} - \text{Aggregate Tested Loss (but not below zero)}
\]

Pursuant to Section 951A, net CFC tested income is a U.S. shareholder-level calculation based on its CFCs’ tested income and tested loss. Specifically, a U.S. shareholder’s “net CFC tested income” for any taxable year is the excess of the shareholder’s aggregate pro rata share of the tested income of each CFC over its aggregate pro rata share of the tested loss of each such CFC.

The proposed regulations provide guidance on determining a U.S. shareholder’s pro rata share of its CFC’s tested income or tested loss. In general, under the proposed regulations, tested income is allocated to a U.S. shareholder under proposed Subpart F pro rata share rules, which allocate amounts based on a “hypothetical distribution” of the greater of the CFC’s current year earnings and profits (E&P), or the sum of Subpart F income and tested income. A special rule applies when a tested loss was allocated to a class of stock in a prior year under the rule that allocates tested loss when common stock has no liquidation value. The proposed regulations provide that a tested loss generally is allocated...
solely to common stock, subject to a couple of special rules, one of which applies when preferred stock has accrued but unpaid dividends that exceed E&P, and one of which applies when common stock has no liquidation value. In addition, an “anti-loss trafficking” rule in the proposed regulations applies when there is a mid-year transfer of a tested loss CFC, and generally provides that the acquirer U.S. shareholder gets only a pro rata share of the tested loss for the acquisition year.

**Application to consolidated groups.** Notably, although the tax code provides that the GILTI inclusion is calculated on an individual U.S. shareholder basis, the proposed regulations would permit the GILTI inclusion to be calculated on a consolidated basis, for taxpayers that file a consolidated return. That is, each member of a consolidated group that is a U.S. shareholder of a tested income CFC would determine its GILTI inclusion by taking into account its aggregate tested income, and its allocable share of the consolidated group’s aggregate tested loss, QBAI, and specified interest expense. For this purpose, a member’s allocable share of these consolidated group items would be determined based on its pro rata share of the consolidated group’s aggregate tested income (referred to as the member’s “GILTI allocation ratio”). This approach allows the tested losses (or QBAI) attributable to CFCs owned by one consolidated group member to offset tested income attributable to CFCs owned by another member of the group. The proposed regulations also include rules that generally require the common parent of the consolidated group in certain situations to adjust its basis in a member when the member has a CFC with a tested loss that is used by another group member.

Let’s walk through a simple example to illustrate the different GILTI inclusion results that members of a U.S. consolidated group may have under a U.S. shareholder-by-U.S. shareholder approach versus the aggregate approach of the proposed regulations:

U.S. Corporation (USP) is the parent of a consolidated group that includes three U.S. subsidiaries—USS1, USS2, and USS3. USS1 wholly owns CFC1, USS2 owns 80 percent of the only class of stock of each of CFC2 and CFC3, and USS3 wholly owns CFC4. CFC1 has a $100 tested loss, CFC2 has $200 of tested income, CFC3 has a $200 tested loss, and CFC4 has $480 of tested income. None of the CFCs has QBAI or specified interest expense.

Under the shareholder-by-shareholder approach of the statute, USS1 would not have a GILTI inclusion because USS1 would only take into account CFC1’s tested loss. USS2 also would not have a GILTI inclusion because its 80 percent share of CFC2’s tested income ($160) would be offset entirely by its 80 percent share of CFC3’s tested loss ($160), resulting in zero net CFC tested income. In contrast, USS3 would have a $480 GILTI inclusion, equal to CFC4’s tested income, and USS3 would be unable to take any benefit from CFC1’s tested loss position. (Nor would USS1 be able to benefit from the tested loss in a future year, e.g., if CFC1 had tested income in year 2.)

Now let’s consider how the results might change under the consolidated approach of the proposed regulations.

<table>
<thead>
<tr>
<th>Step</th>
<th>Comments</th>
<th>Results</th>
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</thead>
<tbody>
<tr>
<td>Step 1:</td>
<td>Determine consolidated tested income</td>
<td>USS1: 0</td>
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<tr>
<td>Step 2:</td>
<td>Determine GILTI allocation ratio for each member</td>
<td>Allocation ratio = member’s pro rata share of tested income / consolidated tested income</td>
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<tr>
<td>Step 3:</td>
<td>Determine consolidated tested loss</td>
<td>USS1: 100</td>
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<tr>
<td>Step 4:</td>
<td>Allocate consolidated tested loss</td>
<td>Allocate consolidated tested loss to each member with tested income based on GILTI allocation ratio</td>
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<tr>
<td>Step 5:</td>
<td>Determine GILTI inclusion for each member</td>
<td>GILTI inclusion = allowable share of consolidated tested loss</td>
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**Application to domestic partnerships.** The proposed regulations also provide for a hybrid aggregate/entity approach to U.S. partnerships that are U.S. shareholders of CFCs. Different rules apply depending on whether the partners are themselves U.S. shareholders of one or more CFCs owned by the U.S. partnership. The default rule is that a U.S. partnership that is a U.S. shareholder determines its GILTI inclusion in the same manner as any other shareholder, and its partners take into account their distributive shares of the inclusion amount under the partnership rules. However, if a U.S. partner is itself a U.S. shareholder of one or more CFCs owned by the partnership, the partner takes into account its proportionate share of the partnership’s pro rata share of the relevant CFC items (e.g., tested income, tested loss, QBAI) in connection with the partner’s separate determination of its GILTI inclusion. This approach allows these U.S. shareholder’s partners to determine a single GILTI inclusion amount with respect to all of their CFC investments.

A CFC determines its “tested income” or “tested loss” for a taxable year by starting with its total gross income for the year and subtracting five specific categories of gross income: (i) income effectively connected

![Diagram of the flowchart](image-url)
with the conduct of a U.S. trade or business; (ii) gross income taken into account in determining the Subpart F income of the CFC (Subpart F income exclusion); (iii) amounts excluded from Subpart F income under the “high-tax exception” of Section 954(b)(4); (iv) dividends received from a related person (as defined in Section 954(d)); and (v) foreign oil and gas extraction income. The CFC then reduces this “gross tested income” by the deductions allocable to such gross income under rules similar to Section 954(b)(5). A CFC has “tested income” for a taxable year if its gross tested income exceeds the allocable deductions, and a “tested loss” if its allocable deductions exceed its gross tested income for the year. Unlike Subpart F income, tested income is not limited by a CFC’s current year E&P.

For purposes of determining gross income and allocable deductions, the proposed regulations incorporate the rules in Treas. Reg. 1.952-2 (that apply for Subpart F income purposes), which generally determine the income and deductions of a CFC by treating it as a domestic corporation taxable under Section 11 and applying the principles of Sections 61 and 63. The proposed regulations also generally provide that allowable deductions are allocated and apportioned to gross tested income under the principles of Section 954(b)(5) and Treas. Reg. 1.954-1(c). Thus, the tested income and tested loss of a CFC is determined based on U.S. taxable income principles. As a result, in the absence of guidance on the issue, it appears that the Section 163(j) interest limitation rules would apply at the CFC level to determine a CFC’s tested income or tested loss, as well as for purposes of determining specified interest expense (discussed below).

The proposed regulations specifically disregard the rules of Section 952(c) for purposes of determining the amount excluded from tested income under the Subpart F income exclusion. In general, Section 952(c) contains rules that adjust Subpart F income for Subpart F inclusion purposes, including a rule that limits the amount of Subpart F income to current year E&P, and a separate rule that requires a “recapture” of amounts limited by the one-year E&P rule in a subsequent year. As illustrated in an example in the proposed regulations, the full amount of Subpart F income is excluded from gross tested income for GILTI purposes, regardless of whether the Subpart F income is limited for Subpart F inclusion purposes as a result of current year E&P. On the other hand, the example also illustrates that amounts recharacterized as Subpart F income under the Section 952(c)(2) “recapture” rules are not excluded from gross tested income even though Subpart F income is increased in the year of recapture for Subpart F inclusion purposes.

Under a special coordination rule, for purposes of determining the Subpart F income of a tested loss CFC, the E&P of the CFC are increased by the amount of the tested loss for purposes of applying the Subpart F current year E&P limitation rule. As noted above, despite having a name that refers to intangible income, GILTI tested income may have nothing at all to do with “intangible” income. Rather, tested income effectively is a residual class of income that includes all income other than the five narrow categories of income identified above. Additionally, tested income is not limited to income that is subject to a low rate of foreign tax. Indeed, there is no general exception to the definition of tested income for high taxed CFC income that is not Subpart F income. As a result, for example, high-taxed non-Subpart F income may be swept into the GILTI net even if the income is subject to a foreign tax rate in excess of the U.S. corporate tax rate.

Subpart F income, on the other hand, is carved out of gross tested income only if the income is subject to an effective foreign tax rate of at least 18.9 percent (i.e., 90 percent of the 21 percent U.S. corporate tax rate) and an election is properly made under Section 954(b)(4) and Treas. Reg. 1.954-1(d)(5) to exclude the income from Subpart F income. The high taxed Subpart F exception is quite limited; income that is excluded from Subpart F income under a different exception, such as Section 954(c)(6) or Section 954(h), is not excluded from gross tested income even if it is high-taxed.

Practical Notes: Unlike the computation of Subpart F income, which as discussed above is limited by current year E&P, the computation of tested income or tested loss is based solely on taxable income concepts. Taxpayers that historically have calculated Subpart F income, and prepared Forms 5471, for their CFCs based on E&P principles will need to make certain adjustments for GILTI purposes, to account for items treated differently for taxable income and E&P purposes. This can include, for example, meals and entertainment, personal items, and charitable contributions. In addition, taxpayers with high-taxed income that is not Subpart F income should consider whether it would be beneficial to restructure to convert that income to Subpart F income that is eligible for the Subpart F high-tax exception.

C. Calculating DTIR

DTIR is calculated at the U.S. shareholder level, based on the U.S. shareholder’s pro rata share of its CFCs’ QBAI, as well as its pro rata share of its CFCs’ tested interest expense and tested interest income.

\[
\text{DTIR} = \left(\frac{\text{QBAI}}{\text{E&P}}\right) \times \text{Tested Interest Expense} - \text{Tested Interest Income}
\]

Section 951A creates a fiction that each CFC will earn a 10 percent return on QBAI, i.e., depreciable tangible property used in producing tested income. QBAI is the average of a CFC’s aggregate basis in such “specified property.” Basis is computed quarterly using the alternative depreciation system (ADS) of Section 168(g), regardless of whether a different depreciation method is used for another tax code section. For property placed in service prior to tax reform, the proposed regulations require CFCs to calculate asset basis as if ADS had applied from the date the asset was placed in service. Section 951A incorporates a new dual-use rule that allows for tangible property to be treated as QBAI even if it does not produce any “directly identifiable income,” a term left undefined by the proposed regulations.

Practical Notes: As noted above, CFCs may be required to recompute tangible asset basis for QBAI purposes, to the extent they were not already using ADS. This could include “reviving” assets that were other-
wise fully depreciated under a different method but would still have a useful life under ADS. CFCs could therefore be required to maintain multiple different fixed asset schedules for foreign book and tax, as well as for U.S. book and tax, purposes.

QBAI is calculated on a CFC-by-CFC basis, and a U.S. shareholder calculates its DTIR by aggregating its pro rata share of the QBAI of each of its CFCs with tested income. Significantly, CFCs with tested losses do not have QBAI and, therefore, are not taken into account in the DTIR calculation. This rule creates a harsh cliff effect that results in the complete loss of the QBAI benefit for CFCs with tested loss, regardless of the magnitude of the tested loss or the magnitude of the CFC’s aggregate tangible asset basis.

A U.S. shareholder must reduce its QBAI return by certain “specified interest expense” to arrive at its DTIR. In general, this is the interest expense taken into account in determining the shareholder’s net CFC tested income for the taxable year, to the extent the interest income attributable to such expense is not taken into account in determining such shareholder’s net CFC tested income. The proposed regulations apply an aggregate netting approach for purposes of determining a shareholder’s specified interest expense. Under the proposed regulations, a U.S. shareholder generally reduces its DTIR by the excess of its pro rata share of—

(i) the interest expense of each CFC that is taken into account in determining the CFC’s tested income or tested loss for the year, over

(ii) the interest income of each tested income or tested loss CFC that is included in the CFC’s gross tested income.

Special rules apply with respect to a CFC that is an eligible CFC within the meaning of Section 954(h) or qualifying insurance company within the meaning of Section 954(i). Note that under the specified interest expense rules the interest expense of a tested loss CFC can have the effect of reducing a U.S. shareholder’s QBAI benefit with respect to tested income CFCs, notwithstanding that the U.S. shareholder does not get any QBAI benefit from the tested loss CFC.

Practical Notes: The QBAI rules are particularly harsh to loss CFCs. Taxpayers that have CFCs with significant tangible asset basis should carefully monitor projected income and expenses to ensure the CFCs do not unexpectedly slip into a loss position. If it is not possible to manage a CFC’s loss position, taxpayers should consider whether it would be beneficial to check-the-box on the loss CFC or merge the loss CFC into a CFC with sufficient tested income.

D. Application of the GILTI Deduction for Corporate U.S. Shareholders

U.S. shareholders that are C corporations are allowed a deduction under new Section 250 equal to 50 percent of their GILTI inclusion (as well as any related Section 78 gross-up, discussed below), subject to a taxable income limitation. (The Section 250 deduction is not available to non-corporate U.S. shareholders or corporate U.S. shareholders that are REITs or RICs.) When the full deduction is allowed, the domestic corporation’s effective tax rate on its GILTI inclusion is 10.5 percent (without taking into account foreign tax credits). The deduction percentage is reduced to 37.5 percent in 2026, which reduces the effective tax rate to 13.125 percent. Corporate U.S. shareholders that have a GILTI inclusion with respect to CFCs owned through a partnership are eligible to claim the GILTI deduction.

The GILTI deduction is subject to a taxable-income based limitation that works in conjunction with the deduction for FDII. When a the taxpayer’s GILTI plus FDII exceeds the taxpayer’s taxable income for the taxable year (i.e., GILTI plus FDII plus other income and taking into account any net operating losses) determined without regard to the Section 250 deduction, the excess is allocated pro rata to reduce the taxpayer’s GILTI and FDII for purposes of computing the deduction. The respective deductions for FDII and for GILTI are computed based on these reduced amounts. As a result, taxpayers with little (or no) taxable income for a given year will be unable to claim the full (or any) benefits of Section 250.

E. Aftermath of a GILTI Inclusion: PTI, Basis, and Foreign Tax Credits

PTI and Basis A U.S. shareholder calculates a single GILTI inclusion based on all of its CFCs, which is a departure from the Subpart F inclusion rules that apply on a CFC-by-CFC basis. Nonetheless, similar to a Subpart F inclusion, a GILTI inclusion will increase a U.S. shareholder’s basis in its CFC stock, and will result in “previously taxed earnings,” or PTI, equal to the GILTI inclusion. For these purposes, a U.S. shareholder allocates its GILTI inclusion proportionately to each tested income CFC that contributes to the inclusion, based on tested income (no portion of the inclusion is allocated to a tested loss CFC).

Example: U.S. Parent (USP) wholly owns CFC1, CFC2, and CFC3. CFC1 has tested income of $100; CFC2 has tested income of $50; and CFC3 has tested loss of $60. Neither CFC1 nor CFC2 has QBAI, and none of the CFCs have specified interest expense.

Let’s show the math, first on USP’s $90 GILTI inclusion then on allocation of the inclusion back to CFC1 and CFC2 (the two tested income CFCs).

The amount of the inclusion allocated to CFC1 and CFC2 is treated as Section 959(e)(2) PTI of each entity and, pursuant to Section 959(a), USP will not be subject to U.S. tax when CFC1 and CFC2 distribute their “GILTI PTI.”

Note, the proposed regulations add new rules that adjust a corporate U.S. shareholder’s basis in a tested loss CFC, which apply when the shareholder disposes of the CFC. In general, under these proposed rules, the shareholder’s adjusted basis of the stock in the CFC is re-
duced immediately before the disposition of the stock by the corporate U.S. shareholder’s net used tested loss amount attributable to the stock. 

**Deemed Paid Foreign Tax Credits Domestic Corporations.** Similar to the deemed paid foreign tax credit (FTC) rules for Subpart F inclusions, new Section 960(d) allows U.S. shareholders that are corporations to claim deemed paid FTCs with respect to their GILTI inclusions. The FTCs are limited, however, to 80 percent of the taxes paid or accrued by tested income CFCs; taxes paid by a tested loss CFC are not taken into account. Available FTCs may be further reduced by the U.S. shareholder’s “inclusion percentage.” The inclusion percentage is the U.S. shareholder’s GILTI inclusion divided by its aggregated tested income (from tested income CFCs). As a result, the inclusion percentage will reduce FTCs whenever a U.S. shareholder has a DTIR or tested loss CFCs. U.S. shareholders that claim FTCs must include in income as a dividend under Section 78 a “gross-up amount” equal to the foreign taxes paid or accrued multiplied by the inclusion percentage. Importantly, the Section 78 gross-up is computed by reference to 100 percent of the deemed paid taxes, rather than by reference to the 80 percent allowable for FTC purposes.

For purposes of calculating a domestic corporation’s FTC, there is a new Section 904(d) separate limitation category (basket) for GILTI inclusions. The separate GILTI basket prevents taxpayers from crediting GILTI FTCs against U.S. tax imposed on other foreign source income.

Notwithstanding that the new basket is limited to GILTI inclusions under the statutory language, the preamble to the proposed regulations states that Treasury and the IRS anticipate assigning the Section 78 gross-up amount to the GILTI basket in future proposed regulations. There is no carryforward or carryback allowed for GILTI FTCs. As a result, any FTCs that are not used in a particular year are lost because they cannot be used in any other year.

As discussed above, a domestic corporation generally is allowed a 50 percent deduction for its GILTI inclusion, resulting in an effective tax rate of 10.5 percent. Taking into account the GILTI FTC “haircut,” it may seem that a corporate taxpayer would not owe residual U.S. tax as long as the income is subject to an effective foreign tax rate of at least 13.125 percent (10.5/0.80). Indeed, the legislative history to GILTI includes a statement to that effect. As generally described above, however, attributable foreign taxes will be reduced when the U.S. shareholder’s inclusion percentage is less than 100 percent. Moreover, absent guidance to the contrary, it appears that U.S. shareholder level expenses, such as interest expense, would be allocated to the GILTI basket, which could further limit FTCs. As a result, a taxpayer may not be able to access all of its GILTI FTCs, which could result in residual U.S. taxation on a GILTI inclusion even when the effective foreign tax rate on the attributable foreign taxes are in excess of 13.125 percent.

Let’s revisit the facts above and now layer on FTC implications. For this purpose, let’s assume that CFC1 paid $10 of foreign income taxes attributable to its tested income, CFC2 paid $2 of foreign income taxes attributable to its tested income, and CFC3 paid $5 of foreign income taxes. As a reminder, USP in our example has a GILTI inclusion of $90.

This example illustrates that USP will owe an additional $5.28 of residual U.S. federal income tax on its GILTI inclusion. Additionally, USP cannot credit any portion of the foreign taxes paid by CFC3 because CFC3 had a tested loss.

**Practical Notes:** There has been considerable debate and uncertainty regarding how expenses are allocated and apportioned to GILTI. We expect Treasury and the IRS to address this issue in the forthcoming FTC regulation package. Notwithstanding the lack of clear guidelines, the increased importance of expense allocation after tax reform may justify revisiting reasonable allocation methodologies.

**Individuals.** U.S. individuals that are treated as U.S. shareholders of CFCs (including individuals that own a CFC through a domestic partnership or S corporation)
are able to claim deemed paid FTCs if they make an election under Section 962. In general, an individual that makes a Section 962 election is subject to tax on her GILTI inclusion if she were a domestic corporation, and can claim foreign tax credits on her GILTI inclusion as if she were a domestic corporation. Under proposed Section 962 regulations, the GILTI deduction under Section 250 would not be taken into account in determining the tax due in connection with a Section 962 election.

Practical Notes: A Section 962 election results in an additional layer of tax because a distribution of the earnings attributable to the inclusion for which the election was made is subject to tax to the extent it exceeds the tax paid on the inclusion. This distribution would be PTI that would be excludable from income if the Section 962 election were not made. Taxpayers should model the consequences of making a Section 962 election to determine the extent to which the election would be beneficial.

F. Proposed Anti-Abuse Rules.

The proposed regulations contain four specific anti-abuse rules. Two of the anti-abuse rules apply to basis created by certain transactions that occur during the transition period between Jan. 1, 2018, and the beginning of a CFC’s first taxable year to which the GILTI rules apply (i.e., the “gap” period or “donut” period). In general, under these rules, when certain assets are transferred by a fiscal year CFC to a related CFC during the transition period in a transaction that increases the basis of the assets in a tax-free manner, the increased basis may be ignored for certain GILTI purposes. Specifically, under one rule, any deduction or loss attributable to the increased basis of depreciable or intangible property is disregarded for purposes of determining tested income or tested loss. Under a similar rule, any deduction attributable to the increased basis of depreciable or intangible property is not taken into account for QBAI purposes. These rules apply when the objective requirements in the proposed regulations are satisfied; there is no requirement to have any bad intent (such as an intent to avoid the GILTI rules). When applicable, these proposed rules apply only for GILTI purposes and not for other purposes, such as Subpart F.

Practical Notes: Taxpayers should review all CFC-to-CFC transactions during any transition periods to determine whether the anti-abuse rules apply, keeping in mind that the tested income/loss rules apply to both depreciable tangible property and amortizable intangible property.

The proposed regulations also include an anti-abuse rule that disregards “temporarily held” property for QBAI purposes. This rule generally applies when a CFC holds property temporarily, but over at least one quarter end, provided that the property was acquired by the CFC with a principle purpose of reducing the GILTI inclusion of any U.S. shareholder. Importantly, notwithstanding this general rule that requires a bad intent to avoid the GILTI rules, the proposed regulations also provide that the anti-abuse rule applies automatically for any property that is held for less than twelve months and over a quarter end.

Practical Notes: The proposed “per se” rule that deems the “temporarily held” anti-abuse rule to apply whenever property is held for less than 12 months and over a quarter end appears broad enough to pick up ordinary course transactions that otherwise could be excluded under the principal purpose requirement in the general rule.

The proposed regulations also contain an anti-abuse rule that applies in determining a U.S. shareholder’s “pro rata share” for Subpart F and GILTI inclusion purposes. This rule broadly applies to any transaction or arrangement that is part of a plan the principal purpose of which is the avoidance of federal income taxation. This rule disregards the transactions and arrangements in determining the U.S. shareholder’s pro rata share of Subpart F income and certain CFC items for GILTI purposes, including tested income and QBAI. There are no examples that illustrate this proposed rule.

G. Reporting GILTI

The proposed regulations modify the Section 6038 regulations to generally require each U.S. shareholder that directly or indirectly owns stock of a CFC to annually file a new Form 8992, U.S. Shareholder Calculation of Global Intangible Low-Taxed Income, which includes certain information regarding each CFC in which it is a U.S. shareholder. As of the date of this article, the IRS has issued a draft Form 8992 (see https://www.irs.gov/pub/irs-dft/f8992—dft.pdf), along with two-page draft instructions (see https://www.irs.gov/pub/irs-dft/f8992—dft.pdf). U.S. shareholders generally also will be required to file new Schedule I-1, Information for Global Intangible Low-Taxed Income, with their annual Forms 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations. As of the date of this article the IRS has released a draft of Schedule I-1 (see https://www.irs.gov/pub/irs-dft/f5471sii—dft.pdf). The Form 8992 and Schedule I-1 do not include any information regarding foreign tax credits.

Conclusion

For certain taxpayers, the new GILTI rules likely will have the broadest impact of any of the international tax reform provisions. Every CFC and U.S. shareholder will be impacted by the GILTI rules and modeling is critical to determine the GILTI implications of maintaining or changing current structures. The proposed FTC regulations that are expected to be released later this year will be critical to these modeling and planning efforts, particular with regard to expense allocation. It also is important to consider the impact of the GILTI rules with FDII and the Section 59A base erosion and anti-abuse tax or “BEAT” rules, as planning to address one of these regimes may have collateral consequences for the other regimes.

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