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FDII and GILTI – The Carrot and Stick of International Tax Reform

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- More than 5,400 employees
- Offices coast to coast
- We serve nearly 6,000 privately held manufacturers and distributors

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Speaker Introductions

Jill Boland, JD, LLM

Director, Global Tax Services

Oak Brook, IL

Jill has six years of international tax experience, with a total of nine years of experience. Experienced in inbound and outbound international transactions involving C corporations, partnerships, and individuals. Experience with issues surrounding foreign tax credits, corporate restructuring, subpart F income, and permanent establishment.

Speaker Introductions

Leslie Boyd, CPA

Tax Principal

Indianapolis, IN

Leslie is a principal in CLA's Manufacturing industry group and leader of the Manufacturing industry for the Indianapolis office. Leslie has more than ten years of experience in public accounting, specializing in tax services for multi-state and multinational C corporations, S corporations, and partnerships.

Learning Objectives

At the end of this session, you will be able to:

- Recognize who is impacted by the GILTI inclusion provisions
- Recognize how the GILTI inclusion is calculated and credits and deductions that can offset the GILTI inclusion for certain taxpayers
- Recall the foreign derived intangible income deduction (FDII) as a U.S. export incentive.
- Identify tax re-structuring options that may be able to mitigate the impact of GILTI inclusions on your business.

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Agenda

- Technical Overview
- GILTI – Case Study
- GILTI - Key Observations
- FDII Overview

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Technical Overview

GILTI Technical Overview

- New IRC 951A anti-deferral regime
  - US shareholders of CFC(s) may be subject to an annual deemed GILTI inclusion (similar to Subpart F)
  - GILTI is measured on an aggregate CFC basis rather than on an individual CFC basis

GILTI Technical Overview, cont'd.

- GILTI is included in the US shareholder's income in the applicable tax year
- New IRC Section 250 allows a GILTI deduction to US shareholders that are C corporations:
  - The deduction is equal to 50% of the US shareholder's GILTI plus the amount of any deemed dividend (under IRC Section 78) attributable to GILTI
    - ◊ Results in GILTI ETR of 10.5% for US corporations
  - The deduction is reduced to 37.5% for tax years after 2025
    - ◊ Results in GILTI ETR of 13.125% for US corporations
- *Individuals and pass-through entities are* ***not eligible*** *for the GILTI deduction*

GILTI Technical Overview, cont'd.

- US shareholders that are C corporations are also entitled to a GILTI FTC
  - 80% of foreign taxes paid by CFCs that are attributable to GILTI
  - No carryforward or carryback is allowed for unused GILTI tax credits
  - GILTI is a separate basket of foreign source income for FTC purposes
- *Individuals and pass-through entities are **not eligible** for the GILTI FTC*
- <u>Does not apply to only foreign intangible income</u>
- Significant impact to:
  - Individuals and pass-through entities
  - Businesses light in PP&E
  - Businesses in tax holidays
  - Businesses in low-tax enterprise zones

GILTI Terms

Net tested income (loss)

- Aggregate net income (or loss) of a shareholder's CFCs other than:
  - Effectively connected income of US trade or business (ECI)
  - Subpart F income
  - Income excluded from foreign base company income by reason of high-tax exception
  - Dividends received from a related person
  - Foreign oil and gas extraction income

GILTI Terms, cont'd.

Net deemed tangible income return

- US shareholder's deemed return on tangible assets held by the relevant CFC, generally based on the CFC's basis in its qualified business asset investment ("**QBAI**")

QBAI

- The quarterly average of the adjusted tax bases in depreciable tangible property used in its trade or business to produce the relevant income (loss).
- Taxpayers must use the straight-line depreciation method for purposes of this calculation

GILTI Terms, cont'd.

GILTI Tax Credit	• US shareholders that are C corporations are eligible for an 80% tax credit for paid foreign taxes attributable to the GILTI amount.
Inclusion percentage	• Ratio of the US shareholder's GILTI amount divided by aggregate tested income.
Tested foreign income taxes	• The foreign income taxes paid or accrued by a CFC that are properly attributable to the CFCs' tested gross income.
GILTI FTC Basket	• The US shareholder's GILTI is separately basketed. • GILTI basket income is apparently subject to normal expense allocation provisions under new Section 904(b)(5)

GILTI Example – Individual vs. Corporation

- FACTS
  - US corporation/individual directly owns 1 CFC
  - After applying the income testing rules, we have determined that CFC earned $50,000 of tested income and has $8,000 of associated foreign income taxes
  - CFC recognized $2,000 of interest expense
  - After calculating QBAI, we have determined that CFC has $18,000 of qualified business assets

GILTI Example, cont'd.

			US Parent	
Step	**Item**	**CFC**	**Individual**	**Corp**
Step 1: Tested Income	Tested income	50,000	50,000	50,000
	Tested loss	-	-	-
	Net CFC tested income		50,000	50,000
	Tested foreign income taxes	8,000	8,000	8,000
	Foreign ETR on tested income	13.79%	13.79%	13.79%
Step 2: QBAI	Qualified Business Asset Investment (QBAI)	180,000	180,000	180,000
	10% of QBAI		18,000	18,000
	Interest expense reduced tested income and corresponding income not included in tested income	2,000	2,000	2,000
	Net deemed tangible income		16,000	16,000
Step 3: Calculate GILTI	GILTI		34,000	34,000

GILTI Example, cont'd.

Step 4: US Inclusion	Inclusion %		68%	68%
	Deemed FTC before 20% reduction			5,440
	Deemed FTC after 20% reduction			4,352
	Grossed-up GILTI		34,000	39,440
	50% deduction			19,720
	TI before credit and expense		34,000	19,720
	Expense allocated to GILTI Basket			
	GILTI for FTC limitation		34,000	19,720
	Tax Rate		37%	21%
	FTC limitation			4,141
	TI before FTC		34,000	19,720
	Tax Rate		37%	21%
	US tax liability before credit		12,580	4,141
	FTC			4,141
	US tax on GILTI		12,580	-

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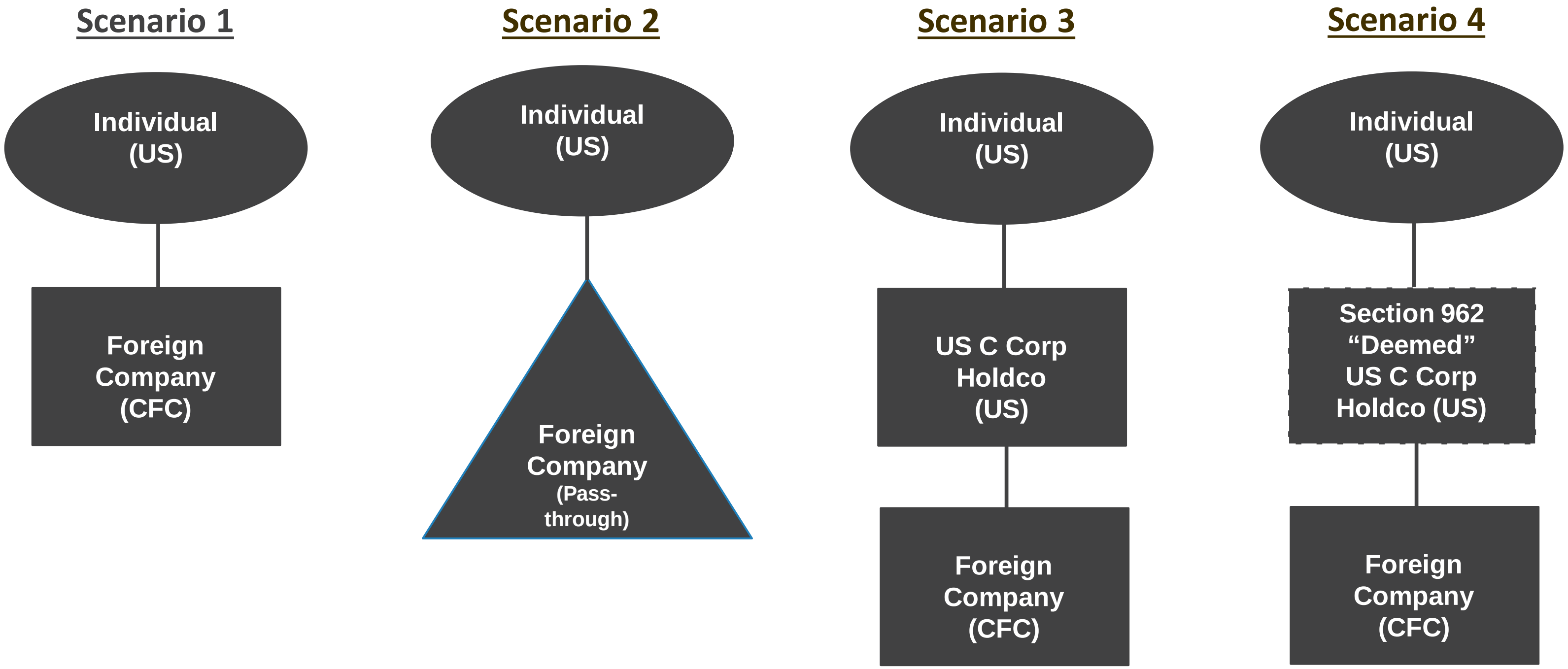
GILTI Planning Case Study

Planning Scenarios

- Status quo/no planning (Scenario 1)
- “Check-the-box” conversion of controlled foreign corporation to foreign partnership (Scenario 2)
- Transfer of controlled foreign corporation stock to US domestic C corporation (Scenario 3)
- IRC Section 962 election (Scenario 4)

Legal Structure Comparison



Assumptions

Assumptions	
Tax Rates	
US Individual:	
Federal - Ordinary	37.0%
Federal - Qualified Dividends	23.8%
State, net of federal benefit	5.0%
US Corporation:	
Federal	21.0%
State, net of federal benefit	5.0%
Foreign Company (FC):	
Corporate Income Tax	20.0%
Dividends WHT	10.0%
Other Items	
US Individual Salary	$ -
FC's QBAI	$ 2,000,000
FC's pre-tax income	$ 10,000,000

Highlights

- US Individual is a United States citizen who is taxed at the highest federal ordinary income tax rate of 37%. We have assumed a state income tax rate of 5%, net of federal tax benefit.
- US Individual owns Foreign Company which is subject to a corporate income tax rate in its home country at a rate of 20%.
- Our computations assume all earnings of Foreign Company will be repatriated to the United States to the ultimate shareholder in the year earned, thereby attracting a withholding tax on dividends at a rate of 10%.
- We have assumed federal/state tax conformity but state income tax rules may vary from federal.

Cash Flow & Effective Tax Rate Comparison

Cash Flow & ETR Summary

	Scenario 1	Scenario 2	Scenario 3	Scenario 4
Foreign Company:				
Taxable income	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Less: Corporate income tax	$ 2,000,000	$ 2,000,000	$ 2,000,000	$ 2,000,000
Net cash flow	**$ 8,000,000**	**$ 8,000,000**	**$ 8,000,000**	**$ 8,000,000**
US C Corp Holdco:				
Taxable income	N/A	N/A	$ 4,875,000	$ 9,950,000
Add:	N/A	N/A		
GILTI deduction	N/A	N/A	$ 4,875,000	$ -
Foreign DRD	N/A	N/A	$ 200,000	$ -
Disallowed Section 78 Gross-up	N/A	N/A	$ 50,000	$ 50,000
Less:	N/A	N/A		
Worldwide corporate income tax	N/A	N/A	$ 3,043,750	$ 3,297,500
Net cash flow	**N/A**	**N/A**	**$ 6,956,250**	**$ 6,702,500**
US Individual:				
Taxable income	$ 8,000,000	$ 10,000,000	$ 6,956,250	$ 6,702,500
Less: Individual income tax	$ 3,333,600	$ 4,200,000	$ 2,003,400	$ 1,930,320
Net cash flow	**$ 4,666,400**	**$ 5,800,000**	**$ 4,952,850**	**$ 4,772,180**
Effective tax rate:				
Worldwide Taxes	$ 5,333,600	$ 4,200,000	$ 5,047,150	$ 5,227,820
divided by-				
Worldwide cash flow, before taxes	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Worldwide Effective tax rate	**53.34%**	**42.00%**	**50.47%**	**52.28%**

Advantages vs Disadvantages Summary**

	Scenario 1
Advantages	-No restructuring expenses required.
Disadvantages	-Inability to defer or reduce federal income tax on GILTI income through indirect foreign tax credits and 50% GILTI deduction.

	Scenario 2
Advantages	-Allows for flow-through of foreign partnership's income taxes as foreign tax credits to offset against US partner's federal income tax liabilities.
Disadvantages	-Conversion of CFC to partnership could trigger taxable gain to shareholder. This restructuring cost could diminish or eliminate any cash flow savings otherwise achieved by converting the foreign corporation to a flow-through entity for US tax purposes.

**Please note that proper transfer pricing of related party transactions must be taken into account to ensure accurate measurement of a US shareholder's GILTI inclusion.

Advantages vs Disadvantages, cont'd.

	Scenario 3
Advantages	-Federal income tax savings on GILTI income generated by a combination of lower US C corp tax rate, 50% GILTI deduction, and indirect foreign tax credits provides US C Corp Holdco with cash to reinvest in its business.
Disadvantages	-Structure may be complex and expensive to maintain. -Cash flow benefits may not be as significant if US individual shareholder is in lower tax bracket or if US C Corp Holdco pays frequent dividends to its shareholders.

	Scenario 4
Advantages	-Federal income tax savings on GILTI income generated by a combination of lower US C corp tax rate and indirect foreign tax credits under Section 962 election reduces US Individual's federal income tax on GILTI income.
Disadvantages	The 50% GILTI deduction and/or Section 245A 100% foreign dividends received deduction ***may not be*** allowed to US Individual under the Section 962 election. We are awaiting issuance of Treasury Regulations to clarify this issue.

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Key Observations

Observations (General)

- Awaiting guidance in the form of regulations
- Draft IRS form has been released
- GILTI will apply to U.S. persons doing business outside the US in corporate form
- GILTI is particularly punitive to U.S. individuals and pass-through entities
- Model, model, model

Observations (Planning)

- US Treasury is planning to issue tax regulations under IRC Section 951A later this year. Issues that need clarification include whether-
  - The 50% GILTI deduction and/or Section 245A 100% foreign DRD are permitted under Section 962 election
  - A full year amount of GILTI inclusion income can be shifted if CFC stock is transferred before tax year end
  - The IRS will apply business purpose/economic substance anti-abuse rule to formation of domestic C corporation “blockers”
  - Consider personal holding company and accumulated earnings tax for C corporation “blockers”

Observations (Other)

- Consider various factors when evaluating legal entity restructuring alternatives including but not limited to-
  - State tax treatment of GILTI income inclusions
  - Dividend distribution and earnings reinvestment policies
  - Unrealized taxable gains on CFC stock
  - Complexity, cost, and substance of domestic C-Corp blocker
  - Individual shareholder-level FTC capacity & other tax attributes
  - Long-term plans to domesticate operations (and related tax incentives); current tariff environment
  - Timing of shareholder liquidity event

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Foreign Derived Intangible Income ("FDII")

Foreign-Derived Intangible Income (FDII)

- Domestic C corporations that have income derived from sales of property or provision of services to foreign persons are eligible for FDII deduction.
- A corporation's intangible income for this purpose is not based on its intangible assets; rather, a corporation is deemed to have intangible income to the extent that its income exceeds a presumed rate of return on its tangible assets.
- Subject to certain limitations, a domestic C corporation may deduct 37.5 percent of its FDII during the taxable year through 2025, resulting in an effective tax rate of 13.125 percent on such income. Beginning in tax years after 2025, the FDII deduction is reduced to 21.875 percent of a C corporation's FDII, resulting in an effective tax rate of 16.406 percent on such income.

Calculating FDII Deduction

1. Calculate deduction eligible income (DEI)
   - DEI=gross income – deductions
   - Subpart F and GILTI income are excluded.
2. Calculate foreign-derived deduction eligible income (FDDEI)
   - Eligible income is attributable to either the sale of property to a non-US person for a foreign use or to services provided by the corporation to any person outside the US.
   - The statute does not define "property".
   - Foreign use includes any use, consumption, or disposition not within the US.
   - Special rules for transactions between related parties.
3. Calculate deemed intangible income (DII)
   - DII=DEI – deemed tangible income return
   - Deemed tangible income return=10% * qualified business asset investment (QBAI)
   - QBAI is the average of the adjusted bases in specified tangible and depreciable property used in trade or business determined on a quarterly basis of the table year.
4. Calculate FDII
   - FDII/DII=FDDEI/DEI
5. Calculate FDII deduction (37.5%)

FDII Example

Deduction Eligible Income (DEI)	100,000
Less: Deemed Tangible Income Return (QBAI * 10%)	-
Deemed Intangible Income (DII)	100,000
Foreign-Derived Deduction Eligible Income (FDDEI)	100,000
Percentage of Foreign-Derived Deduction Eligible Income (FDDEI) to Deduction Eligible Income (DEI)	100% *(100,000/100,000)*
Foreign-Derived Intangible Income (FDII)	100,000 *(100% * 100,000)*
Less: 37.5% Deduction for FDII	(37,500)
Taxable Income	62,500
US Tax @ 21%	13,125
Effective Tax Rate	13.125%

Outlook for FDII

- A group of European Union finance ministers wrote in 2017 that the foreign-derived intangible income regime could qualify as an illegal export subsidy under the WTO. The U.S. law has not yet been brought before the WTO.
- U.S. government officials have said FDII is intended to act as a counterpart to the global intangible low-taxed income, or GILTI, provision, and that together, the two provisions work to neutralize corporations' decision on whether to locate assets at home or abroad.
- The WTO has not yet considered FDII's legality, because no one has brought the case before the organization yet. Before the EU moves to bring any challenge before the WTO, it is waiting to see more Treasury guidance on the new laws.

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Questions?

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- 199A and Qualified Business Income – Thursday, October 18 at 11 am cst
- Year-End Tax Planning – Wednesday, November 7 at 11 am cst

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