IPRPD
International Journal of Business & Management Studies
ISSN 2694-1430 (Print), 2694-1449 (Online)
Volume 03; Issue no 04: April, 2022

The Application and Future of the U.S. Global Intangible Low-Taxed Income Tax

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Abstract

This paper is prepared to take a look at a unique tax provision in the United States 2017 Tax Act (Tax Cuts and Jobs Act of 2017) dealing with foreign earnings of United States multinational firms that are engaged in business activities in many countries throughout the world. This act dramatically changed the tax status of typical foreign earnings of United States multinational corporations as far as United States taxation is concerned. However, in light of this dramatic change, the unique tax provision that was also added in the United States tax law in the 2017 Tax Act that this article addresses tries to ensure that that dramatic change in the tax status of typical foreign earnings of United States multinational corporations did not go too far. This paper looks at this unique tax provision in terms of its purpose, application and, as much as possible, its future in United States tax laws.

Keywords: GILTI; Foreign Earnings; Multinational Corporations; Intangible Assets; Subpart F Income

INTRODUCTION

The Tax Cuts and Jobs Act of 2017[1] for the United States was in many ways a unique tax policy. This legislation addressed numerous domestic tax matters but had particular interest in effecting tax policies regarding United States multinational corporations doing business outside of the United States. This legislation moved the United States closer to a Territorial Tax System where foreign earnings of United States multinational corporations would not be subject to United States tax at all leaving only domestic earnings of multinational firms being subject to United States corporation taxation. This was a great departure from the United States longstanding worldwide tax policy of taxing United States entities (and individuals) on all income regardless of where the income was earned.

In addition to addressing the typical foreign earnings of United States multinational corporations, the 2017 Tax Act also introduced a new Internal Revenue Code section to capture other foreign earnings of United States multinational corporations. The new code section is Section 951A (***GLOBAL INTANGIBLE LOW-TAXED INCOME INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS***). The primary purpose of the Global Intangible Low-Taxed Income provision (or Tax) (known as GILTI or GILTI Tax) is to counter United States multinational corporations that choose to take advantage of the shift to a Territorial Tax System by keeping or expanding business activities outside of the United States (including transferring certain assets outside of the United States). Since the typical foreign earnings are no longer subject to United States corporation taxation (even at the reduced corporation tax rate of 21% beginning January 1, 2018 for domestic corporation earnings only), there may be incentives for United States multinational corporations to continue to conduct business abroad and/or shift income producing assets abroad. The GILTI Tax is designed to tax United States corporations for earnings on non-tangible assets of their multinational operations.

The 2017 Tax Act introduced a specific code section to specifically and solely address steps taken by (or might be taken by) United States Multinational Corporations to shift certain income producing assets outside of the United States. The purpose of this article is to take a glance at this new code section and, to the extent possible, gleam as to how it has been understood and applied in its initial stages. Moreover, this article takes a look at the viability and survival of this new code section.

DEFINITION OF GILTI TAX

In its very technical sense, Global Intangible Low-Taxed Income is defined as the excess (if any) of a United States Shareholder's **Net** Controlled Foreign Corporation (CFC) "***Tested Income***" ("***Net Tested Income***") for a taxable year

[1] Public Law 115-97 (Tax Cuts And Jobs Act of 2017).

over the shareholder's "***Net Deemed Tangible Income Return***" for such taxable year.[2] This statutory definition may need some simplification. A United States Shareholder is defined as a shareholder in a Controlled Foreign Corporation owning ten percent (10%) or more (owned directly, indirectly and constructively) of the combined voting power or the total value of shares of all classes of voting stock of a foreign corporation. A Controlled Foreign Corporation is any non-United States corporation in which more than fifty percent (50%) of (1) the total combined voting power of all classes of stock entitled to vote or (2) the total value of the stock of the corporation is owned by United States Shareholders on any day during the taxable year of the foreign corporation. (The offshore subsidiaries of most multinational United States parent corporations are Controlled Foreign Corporations). "***Tested Income***" of a Controlled Foreign Corporation is defined as the excess (if any) of the Gross Income of the Controlled Foreign Corporation without considering any of the following:

(a) Any income described in Section 952(b) (Income from sources within the United States which is effectively connected with the conduct by such corporation of a trade or business within the United States unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.)

(b) Any Gross Income taken into account in determining the Subpart F Income of the Controlled Foreign Corporation. (Subpart F Income is certain types of income earned by a Controlled Foreign Corporation that are included in the United States Gross Income of United States Shareholders of such entity when generated and not necessarily when or if distributed to the shareholders.)

(c) Any Gross Income excluded from the Foreign Base Company Income (as defined in section 954 - Foreign Personal Holding Company Income; Foreign Base Company Sales Income; Foreign Base Company Services Income) and the insurance income (as defined in section 953) of the Controlled Foreign Corporation by reason of section 954(b)(4), (Insurance Income earned in the foreign country that is taxed by the foreign country at a tax rate of greater than ninety percent (90%) of the maximum United States tax rate imposed on corporations (domestic earnings) which is 21% beginning January 1, 2018.)

(d) Any Dividend received from a related person which is an individual or entity which controls the Controlled Foreign Corporation or is controlled by the Controlled Foreign Corporation or an entity which is controlled by the same person or persons which controls the Controlled Foreign Corporation,

(e) Any foreign oil and gas extraction income (as defined in section 907(c)(1)) of the Controlled Foreign Corporation (Taxable Income derived from sources outside the United States from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells, or the sale or exchange of assets used by the taxpayer in the trade or business of extraction of minerals from oil or gas wells.)

Over the deductions (including taxes) that are properly allocable to such Gross Income (as illustrated above). If the deductions exceed the Gross Income (as illustrated above), the result will be "***Tested Loss***" (rather than Tested Income).

"***Net***" Tested Income of a Controlled Foreign Corporation for a United States Shareholder for any taxable year is the excess (if any) of the aggregate total of the shareholder's pro-rata share of the Tested Income of each Controlled Foreign Corporation in which the shareholder is a United States Shareholder (see definition above and determined for each taxable year) of each Controlled Foreign Corporation (which tax year ends in or with the taxable year of the United States Shareholder) over the aggregate total of the shareholder's pro-rata share of the Tested Loss of each Controlled Foreign Corporation in which the shareholder is a United States Shareholder of each Controlled Foreign Corporation (which tax year ends in or with the taxable year of the United States Shareholder). (Since Subpart F Income of a Controlled Foreign Corporation is limited to Current Earnings And Profits for any taxable year (Section 952(c)(1)(A)), to prevent a double benefit of losses, Current Earnings And Profits of each Controlled Foreign Corporation is increased by the amount of the Tested Loss of the Controlled Foreign Corporation).

Finally, "***Net Deemed Tangible Income Return***" of a Controlled Foreign Corporation for a United States Shareholder's for the taxable year is the excess of ten percent (10%) of the aggregate total of the shareholder's pro-rata share of the "***Qualified Business Asset Investment***" of each Controlled Foreign Corporation in which the shareholder is a United States Shareholder (determined for each taxable year) of each Controlled Foreign Corporation (which tax year ends in or with the taxable year of the United States Shareholder) over the amount of ***interest expense*** taken into account in determining the shareholder's Net Tested Income for each Controlled Foreign Corporation of the shareholder as described above in the determination of Net Tested Income for the shareholder (to the extent the interest income attributable to such expense is not taken into account in determining the shareholder's Net Controlled Foreign Corporation Tested Income).

[2] Section 951A(b)of the Internal Revenue Code Of 1986.

Qualified Business Asset Investment for these purposes is the average of a Controlled Foreign Corporation's for any taxable year aggregate adjusted basis as of the close of each quarter of such taxable year in specified tangible property (A) used in a trade or business of the Controlled Foreign Corporation (in the production of Tested Income solely and pro-rated based on Gross Income for property used in the production of both Tested Income and income that is not Tested Income (pro-rated in the same proportion that the gross income described above in determining Tested Income produced with respect to such property bears to the total gross income produced with respect to such property) and (B) of a type with respect to which a deduction is allowable under section 167 (Depreciable Property). (The Alternative Depreciation System of Section 168(a) is used to determine the adjusted basis of such property with depreciation deductions being allocated ratably to each day during the period in the taxable year to which the depreciation relates).

These extraordinary definitions and steps are needed to determine the foreign earned income of a Controlled Foreign Corporation that is no longer subject to United States corporation taxation beginning January 1, 2018 in the implementation of the modified Territorial Tax System. As shown by these definitions, these steps relate to income (or loss) that is generated from tangible assets. However, income earned from Intangible Assets are not excluded in the modified Territorial Tax System but are subject to United States Taxation as illustrated in the next section of this paper.

APPLICATION OF GILTI TAX

The traditional Territorial Tax System allows for the foreign government where a corporation is legally organized to tax that corporation and the country of the shareholders of the foreign corporation (in the case of United States multinational corporations this is the United States) would not also tax those foreign earnings. Thus, the foreign entity is no longer subject to the Double Taxation of two (2) (or more) national governments. In the modified Territorial Tax System implemented by the United States on January 1, 2018 for United States multinational corporations, the traditional earnings of the foreign entity that is legally organized in a foreign country will not be subject to the United States corporation tax on the traditional foreign earnings of that foreign entity. However, the United States was very cautious in implementing this modified Territorial Tax System so as to not exclude from United States taxation certain other foreign earnings of United States multinational corporations.

As discussed above in the various definitions of the numerous components of the GILTI Tax, foreign earnings generated by ***tangible*** assets of the foreign entity are exempt from United States taxation for the share of those foreign earnings that are attributed to United States Shareholders. However, the modified Territorial Tax System anticipated that many United States corporations (as United States Shareholders) may divert non-tangible assets to their foreign subsidiary (or related entities) to avoid taxation on the earnings (foreign earnings) of these non-tangible assets. The GILTI Tax was included in the 2017 legislation of the Tax Cuts and Jobs Act of 2017 specifically to prevent this tax avoidance by Untied States multinational corporations (United States Shareholders).

To prevent the earnings (foreign earnings) on non-tangible assets diverted outside of the United States from escaping United States taxation, the 2017 legislation included a provision for United States tax to be imposed on the United States Shareholders of Controlled Foreign Corporations when the foreign entity (Controlled Foreign Corporation) generates foreign-sourced income on its intangible assets (such as copyrights, trademarks, patents, franchises, etc.). This is the pure essence of the GILTI (Global Intangible Low-Taxed Income) Tax.

The 2017 Act changed the United States corporation tax rate beginning January 1, 2018 to a flat 21% (down from a high progressive tax system rate of 35% (which had been the case since 1993)). This new 21% flat tax rate is a great incentive for United States multinational corporations to conduct business and/or maintain income generating assets inside of the United States. However, despite this new and attractive low corporation tax rate that many United States multinational corporations find to be very appealing, there are still many countries around the world that have lower effective tax rates on corporate earnings. As such, these lower effective tax rates of other countries still create an incentive for United States multinational corporations to send both business activity and income generating assets outside of the United States. The GILTI Tax imposes a tax on the United States Shareholders of Controlled Foreign Corporations for income earned presumably on intangible assets transferred outside of the United States (as best as the computations described in the previous section of this paper can determine). The GILTI Tax rate that applies to the United States Shareholders (corporate shareholders only (unless election made by noncorporate (individuals and other entities)) shareholders) range from a low of 10.5% (one-half (1/2) of the new corporation tax rate of 21% on domestic earnings resulting effectively in a fifty percent (50%) deduction for tax years of 2018 through 2025) to a high of 13.125% (sixty-two and one-half percent (62.5%) of the new corporation tax rate of 21% on domestic earnings resulting effectively in a thirty-seven and one-half percent (37.50%) deduction for tax years beginning January 1, 2026). (The fifty percent (50%) and thirty-seven and one-half percent (37.50%) deductions are limited when the GILTI Income and Foreign-Derived Intangible Income (FDII) inclusions exceed the taxable income of the corporation (shareholder) before the GILTI deduction. (FDII is the amount of "deemed intangible income" that is attributable to sales of property (including licenses and leases) to foreign persons for use outside the United States or the performance of services to persons, or with respect to property, located outside the United States). Since the

corporation's (shareholder's) taxable income absorbs net operating losses before the GILTI deduction, the GILTI deduction may be limited without any provision for the carryforward of any unused GILTI deduction for the current tax year). Thus, the GILTI Tax is designed to discourage United States multinational corporations from transferring their income producing intangible assets outside of the United States (primarily to countries with corporation tax rates lower than the United States flat 21% corporation tax rate on domestic earnings). Even though the range of the GILTI Tax is significantly below the 21% tax rate on the earnings of domestic corporations, it does impact decisions by United States multinational corporations of whether to transfer income producing intangible assets outside of the United States. (United States Shareholders increase their basis in their stock of the Controlled Foreign Corporation for the GILTI income inclusion effectively treating such increase as income that has already been taxed (i.e., "Previously Taxed Income (PTI)"). (The GILTI Tax is imposed on United States Shareholders regardless of whether a distribution for the amount of the included GILTI income is actually made from the Controlled Foreign Corporation during the tax year).

As illustrated earlier in this article in the numerous definitions of the GILTI Tax, determining the tax base in which the 10.5% or 13.125% tax rate applies involves a rather complex calculation. This tax base is essentially 10% of the Controlled Foreign Corporation's investment in depreciable, tangible business assets minus certain interest expense (i.e., generally equals the amount of the Controlled Foreign Corporation's total income in excess of a Controlled Foreign Corporation's "***Net Deemed Tangible Income Return***") (See discussion above). This complicated calculation essentially forces 10% of the return (earnings) on intangible assets to tangible assets since only the amount of earnings on intangible assets in excess of 10% of the investment in tangible assets are subject to the GILTI Tax. Moreover, the complexity of this calculation may produce unintended results such as a tax rate in excess of 13.125% on the earnings on foreign intangible assets, particularly in foreign countries with a high tax rate. To prevent these unintended results, the United States Department Of The Treasury (and the Internal Revenue Service (IRS)) has issued proposed regulations to ensure that taxation at unintended high tax rates do not occur.

Income taxed under this provision is not classified as Subpart F Income (Income earned by Controlled Foreign Corporations). In addition, the GILTI Tax does not apply to income that is effectively connected to a United States business. The Foreign Tax Credit is allowed to offset or reduce the GILTI Tax (to the extent of eighty percent (80%) of the foreign taxes paid (beginning January 1, 2018)). There is now a separate Foreign Tax Credit basket for GILTI only which the Foreign Tax Credit can be used only against GILTI Tax in the GILTI basket and not other foreign income and no carryover (carryback or carryforward) of the Foreign Tax Credit is allowed for past or future tax years. Since the Foreign Tax Credit is computed in total for the GILTI basket on all foreign income taxes in the basket, foreign taxes paid by one Controlled Foreign Corporation on GILTI income may be used to offset the GILTI Tax on GILTI income earned by a different Controlled Foreign Corporation. Moreover, foreign taxes paid on income that is not included in the Tested Income cannot be used as a tax credit for taxes on GILTI income. According to the Joint Committee On Taxation, the GILTI Tax is projected to generate revenues to the United States Treasury of $112.4 billion dollars over a ten (10) year period.3

FUTURE OF GILTI TAX

The GILTI Tax is a novel tax that requires very complicated calculations to apply. Despite its noble intentions to prevent tax avoidance by United States multinational corporations on earnings generated on intangible assets, the application of this tax is quite burdensome and troublesome. In addition to the unintended consequences of higher tax rates being applied to GILTI income and its complexity, this tax does not naturally fit into the overall scheme of United States Taxation. Considerably more regulations and guidance are needed from the United States Department Of The Treasury (and the Internal Revenue Service (IRS)) to improve the lack of understating of the GILTI Tax and how to effectively apply the tax. Significant simplification or perhaps just outright elimination of the GILTI Tax may be in order. In many respects, the Tax Cuts and Jobs Act of 2017 was passed on a somewhat accelerated pace. As such, some provisions, particularly the GILTI Tax provision, may not have been fully vetted to the extent that normally occurs with broad sweeping tax legislation. This is not necessarily the case with the overall provisions of the Tax Cuts and Jobs Act of 2017 but may be the case with the GILTI Tax provision. As such, the true intentions of this tax provision are not being realized. Accordingly, Congress needs to either revisit this provision or suspend it until it can be more fully examined.

CONCLUSION

The GILTI Tax is a very unique tax with many shortcomings. The tax in and of itself is very complicated. This great complexity of the tax may impede full compliance albeit in perhaps unintended circumstances. The objective of the GILTI Tax is clear but its application is not so clear. The lack of guidance and the potential unintended consequences are additional drawbacks to the GILTI Tax. If no significant changes are made to make the GILTI Tax

[3] The Joint Committee on Taxation.

more understandable and more practical in its application, the GILTI Tax should be eliminated. The complexity of this tax should be more simplified or a completely different approach may be needed to capture the taxation on foreign earnings of intangible assets of United States multinational corporations. Moreover, this tax provision needs further examination so that the intent of the provision may be fulfilled. At the present, this is not the case. The outcome in many cases in the short period of time this provision has been in effect are not what was anticipated. The great uncertainty in the application of the GILTI Tax is troubling. United States multinational corporations are somewhat impaired in the area of appropriate tax planning to the extent that such tax planning relates to the GILTI Tax. Moreover, this uncertainty also impedes decisions on international operations and foreign entities structure for United States multinational corporations. Finally, to perhaps a lesser degree, individual investors in United States multinational corporations may also be adversely impacted in making sound investment decisions regarding multinational corporations. A careful reassessment of the GILTI Tax is very much needed.

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