ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Multinationals

February 5, 2018

On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). Most of the TCJA's provisions took effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system. This memorandum sets forth a few key observations about the TCJA that may be relevant to U.S. multinational groups.

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1. **Summary**

— The TCJA introduces a new baseline regime for corporate taxpayers:

- Corporations benefit from a significantly reduced corporate tax rate of 21%, immediate expensing for acquisitions of tangible property, and a new territorial tax system in which offshore earnings can be repatriated free of U.S. tax.
- These benefits are balanced in part by new limitations on existing tax preferences, including a cap on deductions for net business interest expense and limitations on deductions for net operating losses. As a price for transitioning to the territorial system, U.S. companies must pay a one-time toll charge on their offshore earnings as of the end of 2017.

— In general, the benefits of the baseline regime far outweigh the costs. The net effect of the baseline regime is likely to be extremely favorable for almost all U.S. companies (possibly excluding highly leveraged and/or distressed companies).

— However, the TCJA also introduces two new minimum tax systems that, in many instances, will significantly undermine the benefits of the baseline regime.

- First, the "BEAT" imposes a minimum tax on payments from a U.S. company to foreign affiliates.
- Second, the "GILTI" rule imposes a minimum tax on a U.S. company's offshore income.

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2. **Baseline Regime**

— **Significant Reduction in Headline Tax Rates**

- *For corporations*:
  - The U.S. corporate tax rate is lowered to 21%, with corresponding changes to the deduction for dividends received from U.S. corporations. The rate reduction is effective starting in 2018.
  - The corporate alternative minimum tax is repealed.
  - The reduction in tax rates will mechanically reduce the value of any tax assets owned by U.S. companies (*e.g.*, value of deferred tax assets for NOLs).
- *For non-corporate taxpayers*: The TCJA reduces the tax rate applicable to most income earned through partnerships and other tax-transparent entities, by providing for a deduction equal to 20% of certain business income earned by the non-corporate owners of such entities, subject to a cap based on the entity's wage expenses and asset make-up. The deduction expires after 2025, and does not apply to investment income, compensation, or income from services businesses.

— **Immediate Expensing of Certain Assets**

- U.S. taxpayers may immediately deduct 100% of the cost of certain qualified property acquired and placed in service before January 1, 2023.
- "Qualified property" is, generally, depreciable tangible property (including used property), and does not include shares in corporations, real estate, or intangibles such as goodwill and intellectual property. It also does not include property that is leased rather than purchased.
- Accelerated expensing is also allowed for property acquired and placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it reverts to the previously existing depreciation schedule for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods).
- The short life of the rule will create an incentive to acquire assets eligible for immediate expensing within the next 5 to 10 years.

— **Limit on Net Interest Expense Deductions**

- The TCJA imposes a new limit on net business interest expense deductions for U.S. companies. The limitation applies to any debt outstanding on January 1, 2018. There is no grandfathering.
- This rule, combined with the lower corporate tax rate, will diminish the incentive to allocate the maximum amount of debt to the U.S. in a multinational structure. The rule may increase the after-tax cost of financings by U.S. companies, and may make preferred equity financings more attractive than debt financings in some cases.
- The rule limits the deduction for ***net*** business interest expense to 30% of adjusted taxable income.[1] "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.

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[1] The separate limitation on interest expense deductions based on a worldwide leverage test, which was included in prior versions of the TCJA, was not adopted.

- This may raise the cost of financings for higher-leveraged companies, including capital intensive companies, recently acquired companies and companies in a growth mode funded by debt.
- Particularly in 2022 and later years, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions, due to the change from EBITDA to EBIT. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect, and therefore U.S. borrowers should take into account the switch to EBIT in considering their current debt profile.
  - For example, for a company with 100 of adjusted taxable income equal to EBITDA, and 40 of depreciation, the thin cap limit on interest expense deductions would be 30 through 2021. Starting in 2022, it would be 18. Companies therefore may want to take advantage of the immediate expensing permitted under the TCJA for certain types of tangible assets (described above) to accelerate such investments to pre-2022 years when depreciation is not taken into account in measuring adjusted taxable income for purposes of this interest expense limitation.
- The rule is expected to apply on a U.S. consolidated group-wide basis for domestic corporations. Partnerships are evaluated on a separate entity basis, with rules to allow “excess” adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.
- The rule is consistent with similar changes in law that have been enacted recently by some of our trading partners (*e.g.*, Germany, UK) as a result of the OECD Base Erosion and Profit Shifting (BEPS) project.

— **Limits on Deductibility of Net Operating Losses (NOLs)**

- Under the TCJA, carrybacks of NOLs are no longer allowed, while carryforwards become indefinite. The carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.
- For taxable years beginning after December 31, 2017, a company may use NOLs to offset only up to 80% of the company’s taxable income (with unused NOLs carried forward indefinitely into future years). This 80% cap applies to NOLs arising in taxable years beginning after December 31, 2017.
- To the extent a company has existing NOLs, the reduced 21% corporate tax rate could significantly reduce the benefit of those NOLs, and therefore reduce the value of its deferred tax assets.

— **Shift to a Territorial System**.

- The TCJA adopts a territorial system of international taxation, effective January 1, 2018.
- A one-time transition tax is imposed on the undistributed earnings of foreign subsidiaries generally as of the end of 2017. The transition tax is payable by *any* 10% U.S. shareholder of a foreign corporation (determined on December 31, 2017), if the foreign corporation is either a controlled foreign corporation (CFC) or has at least one 10% U.S. shareholder that is a corporation.
- The tax applies to the foreign corporation’s accumulated earnings as of November 2, 2017 or December 31, 2017, whichever is greater. The earnings are taxed at rates of 8% and 15.5% for corporate shareholders (for earnings invested in tangible assets vs. cash), and 9.05% and 17.54% for investors taxed as individuals and subject to the highest marginal rate.
  - These rules will effectively “unlock” the trapped cash held offshore by U.S. multinationals.

  - Taxpayers can generally elect to pay the tax over 8 years, although there are triggers to accelerate the payment (*e.g.*, sale of all or substantially all of the assets of a taxpayer).
  - There are rules permitting earnings deficits to offset undistributed earnings amounts.
- Under the new system, the dividends received by a U.S. corporation from its 10%-or-greater-owned foreign subsidiaries are generally exempt from tax if attributable to foreign source earnings.
  - This participation exemption is intended to make U.S.-parented companies more competitive internationally, and to encourage these companies to bring offshore cash back into the U.S. It will make managing a U.S. corporation's foreign tax position even more important than it has been to date.
  - The exemption is not available if the foreign corporation is passive foreign investment company (a "PFIC").
  - The exemption also does not apply to so-called "hybrid dividends" (dividends that are deductible by the foreign subsidiary).
  - The exemption is available only to U.S. corporate shareholders who have held the foreign subsidiary stock for at least 1 year (subject to potential tolling rules).
  - Dividends exempted from tax reduce the U.S. corporation's basis in the foreign subsidiary, reducing the U.S. corporation's ability to claim losses on a sale of the subsidiary.
  - A U.S. corporate shareholder may also be able to achieve a negative effective tax rate via this participation exemption by borrowing to finance the purchase of a foreign subsidiary (assuming the interest expense on the borrowing is not subject to the interest expense limitation discussed in item 2 above).
- This is not a full participation exemption. Dividends received by non-corporate taxpayers as well as dividends from subsidiaries in which the U.S. taxpayer does not own 10% of the equity (by vote or by value) will be fully taxable (with potential for foreign tax credit relief). Also, the exemption does not apply to gains from the sale of shares (although gains recharacterized as dividends under section 1248 would be exempt). Thus, there may be a significant benefit to selling foreign assets and deriving exempt dividends as compared to selling foreign shares.
- Despite the exemption for actual dividends from foreign subsidiaries, the TCJA retains the existing rule (section 956) that requires a U.S. shareholder of a CFC to currently include in income the earnings of the CFC reinvested in United States property. Loans from CFCs to U.S. corporate shareholders, pledges of CFC stock to support borrowings of U.S. corporate shareholders, and other investments by CFCs in U.S. property (including owning stock of U.S. affiliates and other U.S. tangible and intangible property) will continue to give rise to deemed dividend inclusions that are fully taxable, and therefore section 956 will continue to constrain the structuring of debt incurred by U.S. entities with significant foreign assets.

3. **BEAT: Minimum Tax on Payments to Foreign Affiliates**

— The TCJA targets earnings stripping or base erosion by imposing a new minimum tax (called the "BEAT", or Base Erosion and Anti-Abuse Tax) on the taxable income of a corporate taxpayer, modified so as to deny deductions for "base erosion payments."

— Base erosion payments are deductible payments from U.S. corporations and U.S. branches of foreign corporations (including any branch deemed to exist as a result of a foreign corporation having "effectively

connected income" (ECI)) to foreign affiliates, excluding (i) cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017), (ii) certain payments for services representing cost reimbursement with no mark-up, (iii) certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers) and (iv) payments that are subject to U.S. withholding tax.

- There are no exclusions for interest, or for most other payments in connection with financial transactions, although as noted above there is an exception for most payments under derivatives that are marked to market.
- There is an unfavorable rule that treats any interest expense that is non-deductible under the limit described in "Limits on Net Interest Expense Deductions" above as paid to unrelated parties for purposes of the BEAT, which maximizes the deductible interest that is treated as paid to related parties and therefore subject to the BEAT.
- The exclusion for cost of goods sold may give rise to planning opportunities for some technology and other companies. Royalties paid to foreign affiliates would be captured by the BEAT, but payments to purchase products with embedded intellectual property would not. Some companies may be able to restructure their intellectual property holdings to take advantage of this distinction.

— The tax due equals the excess of (a) the minimum tax rate applied to the corporation's taxable income after adding back base erosion payments over (b) the corporation's tax liability at the regular corporate rate. Appendix A illustrates how the tax is calculated for a hypothetical multinational business.

- *Rates*:
  - The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years.
  - Increased rates apply to U.S. affiliated groups that include a bank or registered securities dealer: 6% in 2018, 11% in 2019 through 2025 and 13.5% in 2026 and later years. However, as noted above, the base erosion tax does not apply to most payments pursuant to derivatives that are marked to market.
- *Tax Credits*: In calculating a corporation's tax liability at the regular corporate rate for purposes of the BEAT, tax credits are generally taken into account, thereby increasing the BEAT liability. However, in 2018 through 2025, research tax credits and 80% of low-income housing and energy credits are excluded from the calculation, with the effect that these credits can mitigate BEAT liability.
- As demonstrated in Appendix A, the BEAT can have distortive effects on multinational businesses with NOLs.

— The BEAT applies to corporations with at least $500 million in annual gross receipts and for which base erosion payments represent at least 3% of total deductions (2% for a U.S. affiliated group that includes a bank or securities dealer). Aggregation rules apply to test related entities on a group-wide basis. Foreign corporations are subject to the rule if their ECI meets the gross receipts and 3% tests.

— There is significant uncertainty about how the BEAT will be applied in practice and how it will interact with the GILTI regime and the limitations on interest expense. Guidance from the Treasury Department and the Internal Revenue Service is needed to clarify many aspects of the BEAT.

— The TCJA also disallows deductions for interest and royalty payments to foreign affiliates where the foreign recipient is not subject to tax on the payments due to a different characterization of the payment or the recipient (as to its regarded or transparent tax status) by the foreign jurisdiction.

4. **GILTI: Minimum Tax on Offshore Income**.

— Under the TCJA, a U.S. shareholder of a controlled foreign corporation (CFC) must include in income a new category of "global intangible low-taxed income" (or "GILTI"). GILTI is taxed to individual shareholders at 100% of the applicable rate; and taxed to corporate shareholders at 50% of the usual rate (*i.e.*, a 10.5% rate) through 2025, and at 62.5% of the usual rate (*i.e.*, a 13.125% rate) in 2026 and later years.

— Despite its name, GILTI does not focus on intangibles. It is computed as the excess of the CFC's net income for the year (with certain exceptions) over a benchmark rate of return that is keyed off of the CFC's basis in its depreciable assets.

- As a result, GILTI will potentially subject to current U.S. taxes a significant portion of the income of CFCs that (i) earn high returns on assets (*e.g.*, intangibles), (ii) have assets that are not depreciable or have already been significantly depreciated, or (iii) have a business (*e.g.* sales or services) that does not require tangible assets.

— 80% of foreign taxes attributable to GILTI are creditable by corporate shareholders (subject to some limitations, including most notably no carryforwards or carrybacks of excess credits). As a result, a CFC would need to pay tax at an effective rate of 13.125% (through 2025) or 16.41% (in 2026 and later years) in order to avoid triggering tax under this rule.

- Individuals do not get the benefit of these foreign tax credits, and as noted above they are subject to tax on GILTI at 100% of the applicable rate. In other words, individual U.S. shareholders of a CFC may be subject to full tax on their share of GILTI income, no matter how much tax the CFC has paid on that income abroad.

— The TCJA also includes a special 13.125% tax rate (increased to 16.41% in 2026 and later years) for a domestic corporation's "foreign-derived intangible income," which is income related to services provided and goods sold by the domestic corporation for a foreign use, and is calculated in a similar manner as "global intangible low-taxed income." This rule may encourage bringing some offshore intangible assets back to the United States.

— Appendix B illustrates how the GILTI tax is calculated for a hypothetical multinational business, including the unexpected effect the GILTI can have on a business with NOLs.

— Like the BEAT, there are many uncertainties surrounding GILTI, and guidance is needed.

5. **Other Miscellaneous Issues.**

— **Changes to the CFC Attribution Rules**.

- Current law has special rules that subject U.S. shareholders of controlled foreign corporations (CFCs) to tax on certain unrepatriated income (subpart F income) of those CFCs. The TCJA expands these rules to apply to foreign entities with U.S. affiliates even if those foreign entities are not controlled by U.S. companies, and could subject those U.S. affiliates and other U.S. shareholders of the foreign entity to tax with respect to the operation of those foreign entities. This could increase U.S. taxation of multinational groups with U.S. subsidiaries, and create a need for expanded information sharing with unaffiliated U.S. investors.
- In general, a CFC is defined as a foreign corporation that is directly or indirectly controlled by 10% U.S. shareholders who collectively own more than 50% of the foreign corporation's equity. Attribution rules apply for this purpose. However, under prior law, "downwards attribution" from foreign persons to U.S.

persons did not apply (that is, U.S. persons were not treated as owning stock in affiliates that they did not own directly or indirectly). Under these rules, non-U.S. companies that are not majority-owned by U.S. persons, and their subsidiaries, generally were not treated as CFCs.

- The TCJA expands the attribution rules applicable for CFC purposes, allowing downwards attribution from foreign persons to U.S. persons. This could cause a foreign corporation to be treated as a CFC in a situation where significantly less than 50% of the foreign corporation's equity is directly or indirectly owned by U.S. shareholders, particularly where such foreign corporation is affiliated with (but not a subsidiary of) another U.S. corporation. As a result, U.S. shareholders that directly or indirectly own or invest in at least 10% of the equity of a foreign corporation that was not previously treated as a CFC could become liable for tax on subpart F income and subject to the GILTI rules described in paragraph 4 above.
  - This change is effective beginning with the last tax year of a CFC that begins *before* January 1, 2018 (in other words, it will apply to the 2017 tax year for a CFC that is on a non-calendar tax year).
  - An explanation by the House-Senate Conference Committee indicates that the new downward attribution rule is not intended to result in allocations of subpart F income or GILTI to 10% U.S. shareholders who are not otherwise related (at a 50% level) with U.S. entities that are attributed ownership of the foreign corporation. However, the text of the TCJA does not include language to reflect that intent.
- If the TCJA is interpreted as drafted, 10% U.S. shareholders of a non-U.S. company may need the non-U.S. company to provide significant information about its operations and financials to enable the U.S. shareholders to comply with their tax reporting obligations. In extreme circumstances, the U.S. shareholders could seek rights to exercise control over the company's operations to mitigate its own tax exposure. Foreign companies with existing 10% U.S. shareholders, or that seek to attract investments by U.S. shareholders in the future, should examine their contractual obligations to those shareholders and the terms of their equity to evaluate the consequences of this proposed change, and be mindful of the possibility that such shareholders may request information about the company's operations from the parent entity or its investor relations group.
- The TCJA also expands the definition of a 10% U.S. shareholder to also include any U.S. person that owns at least 10% by value (or 10% of voting power, as was the case under previous law).

— **Timing Issues**.

- The TCJA requires most accrual-method taxpayers to take items of income into account for tax purposes no later than the time they are included on the taxpayer's audited financial statements or annual reports, subject to certain exceptions (including an exception for mortgage servicing contracts). The rule generally takes effect beginning in 2018, but is delayed until 2019 for debt instruments with original issue discount.

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APPENDIX A

BEAT: Detailed Overview

The BEAT is payable only by U.S. corporations and branches (or deemed ECI branches) of non-U.S. corporations with average annual gross receipts of at least $500m and "base erosion payments" representing at least 3% of total deductions (2% for a U.S. affiliated group that includes a bank or securities dealer).

Base erosion payments are deductible payments from domestic corporations and branches to foreign affiliates, excluding:

- Cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017);
- Certain payments for services representing reimbursement for costs with no mark-up;
- Certain payments pursuant to derivatives that are marked to market for tax purposes (generally by banks or swap dealers); and
- Deductible payments to the extent they are subject to U.S. withholding tax.

The BEAT equals the excess of (a) the minimum tax rate applied to the corporation's "modified taxable income" over (b) the corporation's tax liability at the regular corporate rate.

- The corporation's modified taxable income equals taxable income after adding back base erosion payments and disregarding the "base erosion percentage" of any NOLs.
- The minimum tax rate is 5% in 2018, 10% in 2019 through 2025, and 12.5% in 2026 and later years. Increased rates (6%, 11%, and 13.5%, respectively) apply to U.S. affiliated groups that include a bank or securities dealer.
- The base erosion percentage equals the taxpayer's deductions for base erosion payments divided by the taxpayer's total deductions (with certain adjustments).
- In calculating tax liability at the regular corporate rate, tax credits are generally taken into account, thereby increasing the BEAT liability. However, in 2018 through 2025, research tax credits and 80% of low-income housing and energy credits are excluded from the calculation, with the effect that these credits can mitigate BEAT liability.

BEAT Example 1

Parent, a non-U.S. corporation, conducts activities through a U.S. corporate subsidiary ("DSub") and a non-U.S. subsidiary ("FSub"). DSub has gross income of 600 in 2019.

DSub purchases parts from FSub at a total annual cost of 150. DSub also incurs 250 in annual interest expense on shareholder debt owed to Parent. DSub does not have any other deductions or any NOLs or credits, and DSub's interest expense deductions are not subject to any limitations.

DSub has 200 in net taxable income (600 gross income minus 150 cost of goods sold and 250 interest expense), so DSub's tax liability at the regular corporate rate is 42 (21% of 200). The full 250 of interest payments are base erosion payments, but the 150 in payments for parts are not. DSub's modified taxable income is 450 (200 net income plus 250 base erosion payments), and the minimum tax rate applied to the modified taxable income yields 45 (10% of 450). DSub's BEAT liability therefore is 3 (45 minus 42). DSub's total tax liability is 45 (42 regular tax liability + 3 BEAT liability).

BEAT Example 2: Credits

The facts are the same as BEAT Example 1, except that DSub has 20 in foreign tax credits available for use in 2019.

As in Example 1, DSub's pre-credit tax liability at the regular corporate rate is 42 and the minimum tax rate applied to DSub's modified taxable income is 45. Taking into account the foreign tax credits, DSub's tax liability at the regular corporate rate is 22. Thus, DSub's BEAT liability is 23 (45 minus 22). DSub's total tax liability is 45 (22 regular tax liability + 23 BEAT liability).

If the credits are low-income housing tax credits instead of foreign tax credits, 16 of the credits (80% of 20) are disregarded in calculating DSub's tax liability at the regular corporate rate. Thus, DSub's tax liability at the regular corporate rate increases to 38 (42 minus 4) and DSub's BEAT liability decreases to 7 (45 minus 38). DSub's total tax liability is 30 (23 post-credit regular tax liability + 7 BEAT liability).

BEAT Example 3: NOLs

The facts are the same as BEAT Example 1, except that DSub has 200 of NOL carryforwards.

DSub's net taxable income is 0 (600 gross income minus 150 cost of goods sold, 250 interest expense, and 200 NOLs[2]), so DSub's tax liability at the regular corporate rate is 0. Assuming DSub's base erosion percentage is 62.5% (250 divided by 400), only 75 of the NOLs (37.5% of 200) are taken into account in calculating DSub's modified taxable income. DSub's modified taxable income is 375 (600 gross income minus 150 cost of goods sold and 75 NOLs), and the minimum tax rate applied to the modified taxable income yields 37.5 (10% of 375). DSub's BEAT liability, and its total tax liability, therefore is 37.5 (37.5 minus 0).

The NOLs reduce regular tax liability (i.e., the right side of the equation) in full, but are discounted by the base erosion percentage before they reduce modified taxable income (i.e. the left side of the equation). As a result, they can have a distortive effect on the BEAT calculation. In this example, where the NOLs reduce taxable income to zero, the BEAT applies to 100% of base erosion payments as well as a portion of the NOLs.

[2] This is a simplifying assumption, as future NOLs can reduce only 80% of regular taxable income.

APPENDIX B

GILTI and FDII: Detailed Overview

Each U.S. shareholder of a CFC includes in gross income such shareholder's share of the CFC's GILTI:

- The CFC's GILTI equals the excess of the CFC's net income (excluding income taxed in the U.S. via subpart F or otherwise, high-taxed income, and certain other amounts) over the "net deemed tangible income return".
- The net deemed tangible income return equals 10% of the U.S. shareholder's pro rata share of the excess of the CFC's basis in tangible depreciable property used in a trade or business over the CFC's interest expense (to the extent such interest expense is taken into account in calculating the CFC's net income).

Individual U.S. shareholders pay full U.S. tax on GILTI. Corporate U.S. shareholders, however, may reduce the U.S. tax on their GILTI in two ways:

- A corporate U.S. shareholder may claim foreign tax credits for 80% of the shareholder's "inclusion percentage" of the foreign taxes paid by the CFC (to the extent those taxes are attributable to the CFC's income taken into account in the GILTI calculation). The shareholder's inclusion percentage equals the CFC's GILTI divided by the CFC's gross income (subject to the exclusions for U.S.-taxed and high-taxed income described above).
- A corporate U.S. shareholder may deduct 50% of GILTI in 2018 through 2025, and 37.5% of GILTI in 2026 and later years.

Separately, U.S. corporate shareholders (but not individuals) benefit from a deduction equal to 37.5% of their "foreign-derived intangible income" (FDII) in 2018 through 2025, and 21.875% of FDII in 2026 and later years:

- A U.S. corporation's FDII equals the corporation's "deemed intangible income" multiplied by the percentage of the corporation's net income (subject to certain exclusions) that is derived from property sold or leased to, or services provided to, unrelated non-U.S. persons.
- The corporation's deemed intangible income equals the corporation's net income (subject to certain exclusions) minus a deemed 10% return on the excess of the corporation's basis in tangible depreciable property used in a trade or business over the corporation's interest expense.

The deductions available to a U.S. corporate shareholder for GILTI and FDII are reduced to the extent the U.S. corporation's aggregate GILTI and FDII exceeds the U.S. corporation's taxable income before those deductions.

GILTI Example 1: Foreign Subsidiary with Intangible Property

Parent, a U.S. corporation, conducts activities through a foreign subsidiary ("FSub"). FSub is an IP holding company with no tangible assets.

FSub has 10,000 of intangible assets. FSub earns an average return of 3% on its assets. FSub's earnings are subject to foreign tax at a 5% rate. The year is 2018.

FSub therefore has pre-tax income of 300 and after-tax profits of 285 (pre-tax income of 300 minus 15 of foreign tax).

FSub does not have any tangible property, so all of its income is subject to the GILTI rules. Parent is thus required to include 300 of GILTI (FSub's pre-tax income) in its income currently, and is entitled to a deduction of 150 (50% of 300).

Parent would have a pre-credit U.S. tax liability of 31.5 (21% of 150) as a result of the GILTI inclusion. But the inclusion brings up 12 of foreign tax credits (80% of 15), so Parent's residual liability is 19.5.

GILTI Example 2: Foreign Subsidiary with Depreciated Tangible Property

The facts are the same as GILTI Example 1, except that FSub's is a manufacturing company that operates through a fully depreciated production facility in 2018, and places a new production facility in service at the beginning of 2019 (with each facility valued at 10,000). As in Example 1, FSub derives 300 of annual pre-tax income from its manufacturing activities and after-tax profits of 285.

All of FSub's income is GILTI in 2018, because it has a big factory but no basis in tangible assets. None of FSub's income is GILTI in 2019, because it has a new factory. All other facts remain the same, yet Parent has a 19.5 liability in 2018 and no liability in 2019.

GILTI Example 3: NOLs

The facts are the same as GILTI Example 1, except that Parent has 50 of NOLs. Parent has no taxable income other than the GILTI from FSub.

Before taking into account the deduction for 50% of GILTI, Parent's taxable income is 250 (300 GILTI minus 50 NOLs). Since the 300 of GILTI exceeds Parent's 250 of taxable income, for purposes of calculating the deduction for 50% of GILTI, GILTI is reduced by the amount of that excess, or by 50. This means effectively that Parent is treated as having 50 of non-GILTI income that is offset fully by the NOLs, and the remaining 250 of GILTI income is offset by a deduction of 50% of that recalculated GILTI amount (*i.e.*, 175). Parent's pre-credit U.S. tax liability on the remaining 175 of income is 26.25 (21% of 125), reduced by 12 of foreign tax credits (80% of 15), for a residual liability of 14.25.

This special rule limiting the 50% GILTI deduction by the excess of GILTI over taxable income effectively causes the NOLs to lose 50% of their value. In Example 1, where Parent had no NOLs, Parent's net taxable income was 150 (300 GILTI minus 150 GILTI deduction). In this Example, Parent has 50 of NOLs, but Parent's taxable income is 175 – i.e., the 50 of NOLs have only reduced taxable income by 25. In other words, NOLs offset GILTI on a dollar-for-dollar basis, notwithstanding the fact that GILTI is generally taxed at 50% of the usual rate. This should be taken into account in assigning value to NOLs: where significant GILTI is expected, the tax benefit of $100 of NOLs may be closer to $10.50 than $21.

GILTI Example 4: Foreign Subsidiary with Individual Owners

The facts are the same as GILTI Example 1, except that FSub is owned 50% by Parent and 50% by X, a U.S. resident individual in the top 37% income tax bracket. FSub has pre-tax income of 300, all of which is subject to the GILTI rules, and pays 15 of foreign tax. The year is 2018.

Parent is required to include 150 of GILTI (Parent's pro rata share of FSub's income) in income currently, and is entitled to a deduction of 75 (50% of 150). Parent would have a pre-credit U.S. tax liability of 15.75 (21% of 75) as a result of the GILTI inclusion. The inclusion brings up 6 of foreign tax credits (80% of 7.5, Parent's pro rata share of FSub's foreign taxes), so Parent's residual liability is 9.75.

X is also required to include 150 of GILTI in income currently, but is not entitled to any deduction or foreign tax credits. Thus, X's tax liability is 55.5 (37% of 150).

X's liability is more than 5 times Parent's.