FDII and GILTI Tax Provisions: Understanding the Carrot and the Stick of Repatriating Income to the United States in Light of Biden Proposals

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ABSTRACT
Former President Donald J. Trump signed into law the Tax Cuts and Jobs Act of 2017 (TCJA), the most sweeping revision of United States (U.S.) tax law since the Tax Reform Act of 1986. One of the most significant provisions in TCJA was the reduction of the U.S. corporate income tax rate from 35% to 21%. This tax reform brought the U.S. corporate rate below the average for most other countries in the Organization for Economic Cooperation and Development (OECD), eliminated the graduated corporate rate schedule, and repealed the corporate alternative minimum tax (AMT). Lowering the corporate tax rate is a pro-growth policy for the U.S. As part of the goal to move the U.S.'s multinational tax policy from a worldwide taxation approach to a territorial tax-based system, TCJA included two international tax provisions called Global Intangible Low-Taxed Income (GILTI) and Foreign Derived Intangible Income (FDII). Legislators believe that the two tax provisions will make U.S. corporations more competitive in the global market and encourage international businesses to expand operations within the U.S. Understanding the GILTI and FDII provisions of TCJA is prudent as the proposals of the Biden administration are anticipated.
Keywords: GILTI, FDII, repatriation, multinational, U.S. corporate income tax, intangibles, controlled foreign corporations.

TAX CUTS AND JOBS ACT 2017
In 2017, President Donald Trump signed the Tax Cuts and Jobs Act of 2017 (TCJA), which included the most extensive overhaul of the U.S. tax law since the Tax Reform Act of 1986 (Gale et al., 2018). As part of the provisions, the U.S. corporate income tax rate was reduced from a progressive tax rate structure that capped out at 35% to a 21%

flat tax rate and repealed the AMT. This brought the U.S. corporate rate below the average for most other OECD countries.

TCJA was enacted partly due to concerns about issues related to the allocation of investment between the U.S. and countries with lower tax rates, as well as the loss of revenue due to the artificial shifting of profit out of the U.S. by multinational firms (Gale et al., 2018). In addition, TCJA included several provisions that are focused on foreign income and deductions, tax credits, and rules to prevent abuses from corporations having foreign income (Kadet & Koontz, 2019). TCJA moved the system of taxing worldwide income with the option of a tax credit for foreign taxes to a territorial system that aims to eliminate the tax on foreign-source income. According to Gravelle & Marples (2020), "prior law reduced the tax on foreign-source income by allowing deferral, which is taxing income of foreign subsidiaries only if it was repatriated or paid as a dividend to the U.S. parent, and cross-crediting of foreign taxes so the credit for high taxes paid in one country could offset U.S. tax on income from a low-tax country."

Under TCJA, the deferral of income from certain profits of tangible assets in a company's investments is eliminated. However, with intangible investments, such as patents and Subpart F income (discussed later), the U.S. retains its worldwide approach but at a lower rate to prevent the erosion of the U.S. tax base. GILTI imposes a minimum tax on derived intangibles, while FDII provides U.S. corporations a reduced tax rate and allows a deduction for intangible income deemed to be generated using foreign intangibles. The legislators believe that these two provisions will encourage corporate operations expansion in the U.S. (Gale et al., 2018).

ROLE OF INTANGIBLES AND TAXATION

Internal Revenue Code (IRC) §197(d) defines intangible by listing them, including goodwill, going concern value, identity rights like franchises, trademarks, or trade names, customer and supplier-based intangibles such as market share and value of future acquisitions of goods or services, and covenants not to compete, among others.

An OECD (2015) report on international tax issues and base erosion and profit shifting explains that intangibles protected by certain established legal rights become intellectual property. Intangibles can also be exploited without being depleted. Thus, products created from intangibles, like software, could result in higher earnings from the decrease of production costs. With increased competition in the digital economy, U.S. corporations focused on intellectual property to gain a competitive advantage.

According to Brand Finance (2019), S&P 500 companies hit a record value of $21 trillion in intangible assets in 2018. Microsoft and Amazon, which are in both the internet and software sectors, have total intangibles valued at $904 billion and $839 billion, respectively. However, most intangibles are not reported in company balance sheets because accounting standards do not facilitate their recognition.

Tax law treats intangibles as intellectual property (Wiederhold, 2014). Under this law, the creator's ownership rights are protected. This, in turn, provides creators the right to

earn returns or recognition from the intellectual property. With tax treaties designed to avoid double taxation, taxes on royalties, for example, are allocated based on the source of the intangible income. However, intangibles other than intellectual property require no tax to be withheld to the holder's country of origin. The income generated would only then be taxed in the recipient's country. Consequently, this creates an incentive for corporations to transfer their intangibles to a low-tax jurisdiction to receive a better tax benefit. U.S. legislators recognize that these transfers to tax havens erode the U.S. tax base.

CONTROLLED FOREIGN CORPORATIONS (CFC)

In understanding the complexities, it is crucial to understand the relationship between GILTI and CFCs. Understanding how GILTI rules overlap with other anti-deferral tax provisions like Subpart F income helps clarify these rules' intent. A CFC is any foreign corporation of which more than 50% of

(1) the total combined voting power of all classes of stock or
(2) the total value of the stock of the corporation,

is owned by a U.S. shareholder. A U.S. shareholder is, in turn, defined as a person who owns 10% or more of

(1) the total combined voting power of all classes of stock or
(2) the total value of the stock of the corporation.

Therefore, shareholders that own less than 10% are disregarded when determining the 50% control limit (IRC §951(b); Treas. Reg. §1.957-1). Furthermore, if a U.S. shareholder owns stock in a foreign corporation on the last day of its year, and that corporation is considered to be a CFC, then that U.S. shareholder must include in gross income their allocated share of GILTI for the year (IRC §951A(a); IRC §951A(e)(2)).

To illustrate a CFC, consider the two following independent examples. Suppose that Alaska Corp. is a U.S. corporation that owns 100% of Software A Inc. in Spain. Software A is a CFC because Alaska Corp. owns more than 50% and at least 10% of the shares. Alternatively, suppose that Wyoming Corp. is a U.S. corporation that owns 15% of Software B Inc. in France, and four other U.S. individuals and corporations each own 11% with the rest owned by foreign entities. Software B would also be a CFC, as U.S. shareholders own more than 50% of it.

Under the old rules, income from a CFC was not taxed by the U.S. until it was repatriated; therefore, corporations had an incentive to try to source income to tax havens rather than to the U.S. The Internal Revenue Service (IRS) wants U.S. shareholders to pay tax now even if the income is received at a later date. For this reason, the U.S. enacted the Subpart F income provision. Subpart F rules overlap with GILTI provisions as both relate to CFCs; however, Subpart F income is primarily dividends and passive income while GILTI is more involved and encompassing. Subpart F income is codified under IRC §952(a) as the sum of insurance income, foreign base company income, international boycott factor income, illegal bribes, and the income derived from an IRC §901(j) foreign country.

GLOBAL INTANGIBLE LOW-TAXED INCOME

Under the GILTI provision the "stick" is that U.S. shareholders of CFCs are taxed on the CFC deemed to be derived from intangibles and denoted "Net CFC tested income (NCFCTI)." NCFCTI is the aggregate annual foreign-sourced earnings of the foreign corporations due to operations, with some exceptions and adjustments. The tested income of the corporation is the corporation's gross income less the deductions that are properly allocable to that gross income, income effectively connected with a U.S. trade or business, Subpart F income, dividends received from related parties, and others (Treas. Reg. §1.957A-2).

The GILTI tax is a minimum tax imposed on certain low-taxed income intended to reduce the incentive to relocate CFCs to tax-havens. GILTI is analogous to the repealed corporate AMT (Auerbach, 2018; Gale et al., 2018). GILTI creates a new type of income for CFCs alongside Subpart F income and concerns all U.S. shareholders of CFCs, despite the legal form of the U.S. shareholder. The U.S. government taxes U.S. corporations on CFC income immediately, whether distributed or not (Slemrod, 2018).

Morse (2019) explains that the mechanics of the GILTI tax when the U.S. corporation wholly owns the CFC is as follows:

(1) GILTI is equal to the non-Subpart F income earned by the CFC, excluding an exempt return of 10% of the adjusted basis of the CFC's tangible assets used in the production of GILTI (IRC §951A(b)(2))

(2) The U.S. parent corporation includes GILTI in its gross income even if the CFC does not repatriate any profit to the U.S. parent corporation (IRC §951A)

(3) The U.S. parent corporation may take a 50% deduction for GILTI, which reduces the effective tax rate on GILTI to half of the U.S. statutory rate from 21% to 10.5% (IRC §250(a)).

Only corporations are eligible for the 50% GILTI deduction (IRC §250(a)). The GILTI tax is further reduced, but not below zero, by 80% of foreign income taxes paid or accrued (IRC §960(d)). This foreign tax credit has its own calculation and may only offset tax on foreign-sourced GILTI under IRC §904(d). Therefore, U.S. corporations with CFC income in low-tax jurisdictions will be most affected by the GILTI tax due to the lack of foreign tax credit. There is no foreign income tax credit carryover or carryback for any excess GILTI foreign tax credits (IRC §904(c)).

Key term definitions are necessary to understand GILTI calculation.

Net CFC Tested Income (NCFCTI) – IRC §951A(c)(1) defines NCFCTI as the aggregate of the U.S. shareholder's pro-rata share of the tested income of each CFC over the aggregate of such shareholder's pro-rata share of the tested loss of each CFC.

Qualified Business Asset Investment (QBAI) – IRC §951A(d)(1) defines QBAI as the average of a corporation's aggregate adjusted bases at the close of each quarter in specified tangible property eligible for depreciation under Section 167.

Net Deemed Tangible Income Return (NDTIR) – IRC §951A(b)(2) defines NDTIR as the excess of 10% of a shareholder's share of a CFC's qualified business asset

investment over the net interest expense of the CFC allocated to that shareholder. Essentially, the U.S. is assuming that 10% of QBAI comes from tangible assets, and the rest subtracted from the NCFCTI comes from intangible assets.
GILTI can then be arranged in an equation such that:

$$GILTI = NCFCTI - NDTIR$$

or

$$GILTI = NCFCTI > NDTIR$$

For example, suppose that Alaska Corporation is a U.S. corporation that owns a CFC in a foreign country with a NCFCTI of $2.5 million with a QBAI of $12 million and a $10,000 interest expense to unrelated parties. Alaska Corporation also paid $100,000 in foreign income taxes related to GILTI.
GILTI is then calculated as:

NCFCTI	**$2,500,000**
QBAI	12,000,000
10% of QBAI	1,200,000
Interest Expense	10,000
NDTIR (10% of QBAI – Interest Expense)	**1,190,000**
Gross amount of GILTI (NCFCTI – NDTIR)	1,310,000
Less 50% deduction (U.S. Corporations only)	655,000
GILTI included in U.S. parent's income (Gross GILTI – 50% deduction)	655,000
U.S. corporation income tax rate	21%
U.S. tax liability	137,550
Less foreign tax credit allowed (80% of total)	80,000
Net U.S. tax liability	**57,550**
Effective tax rate (tax liability / GILTI)	**4.4%**

Goldman (2018), an international tax practitioner, explains a three-step approach for calculating GILTI. She also demonstrates an example of a domestic corporation benefiting from FDII. She provides an excellent resource from a practitioner's point of view.

FOREIGN DERIVED INTANGIBLE INCOME (FDII)
TCJA added a deduction for FDII, the "carrot," in an attempt to create greater incentives for U.S. corporations to locate intangible profits domestically rather than overseas (Dowd & Landefeld, 2018). Whereas the GILTI provision applies to U.S. individuals that are shareholders of CFCs, the FDII provision applies to all U.S. corporations (Camacho & White, 2019).

In IRC §250(a) and Treas. Reg. §1.250(a)-1, a U.S. corporation is allowed to deduct 37.5% of the income treated as FDII (this rate falls to 21.875% for years after 2025). With the U.S. corporate income tax rate of 21%, FDII is effectively taxed at 13.125%

(16.41% after 2025)[1]. The FDII deduction cannot exceed taxable income, however. IRC §250(b) states that FDII of a U.S. corporation is the amount bearing the same ratio to the deemed intangible income as the foreign-derived deduction eligible income bears to the deduction eligible income. Accordingly, FDII is calculated as:

$$FDII = DII \times \frac{FDDEI}{DEI}$$

The first step in calculating FDII is determining the amount of deduction eligible income (DEI) and QBAI. IRC §250(b)(3) defines DEI as the excess of gross income over deductions, including taxes, allocable to such gross income excluding certain categories of income. The exceptions are passive foreign income taxed when earned (Subpart F), GILTI, financial services income, dividends from CFCs, oil and gas extraction income, and foreign branch income. In IRC §250(b)(2), deemed intangible income (DII) is defined as the excess of DEI over the deemed tangible income return of the corporation, which follows the same formula used in calculating GILTI.
As a result, DII is calculated as:

$$DII = DEI - 10\% \text{ of } QBAI$$

Furthermore, foreign-derived deduction eligible income (FDDEI) is defined as any DEI which is derived in connection with a property sold to foreign parties (IRC §250(b)(4); Treas. Reg. §1.250(b)-1). Therefore, the ratio in the FDII equation is the share of DEI that is sold for export (Dowd & Landefeld, 2018). For example, suppose that Alaska Corporation is a U.S. corporation that earned $1 million in net profits selling computers domestically and directly to an unrelated foreign entity. In addition, 25% of the corporation's earnings are from the sale of widgets to the foreign entity, and that Alaska Corporation has $5 million of QBAI. Using the formulas above,
FDII is then calculated as:

DEI	$1,000,000
Less 10% of QBAI	500,000
DII	**500,000**
DII * FDDEI/DEI	500,000 * 250,000/1,000,000
FDII	**125,000**
Deduction to report in Alaska Corporation's tax return (37.5% deduction of FDII)	46,875
Taxable FDII	78,125
Corporate Tax (21% x Taxable FDII)	16,406
FDII Effective Tax Rate	16,406/125,000 = **13.125%**
FDII savings: 21% of $125,000 vs. 21% of $78,125	**$9,844**

[1] This is calculated by taking the tax rate of 21% times the amount left after the deduction or (21% x (100% - 37.5%) = 13.125%. Plugging the rate for after 2025 into this equation we get 21% x (100% - 21.875%) ≈ 16.41%.

The result is taxable FDII for Alaska Corporation of $78,125 and a tax on Alaska's FDII of $16,406. Consequently, Alaska's effective tax rate on its FDII of $125,000 is 13.125%. The FDII deduction produces Alaska $9,844 in tax savings.

INCENTIVES FROM GILTI AND FDII PROVISIONS

When TCJA was enacted, the U.S.'s movement towards a territorial tax system eliminated the additional U.S. tax on foreign profits through a participation exemption. Foreign profits paid to U.S. parent corporations in the form of dividends are fully deductible against taxable income through dividend-received deductions. Thus, unlike pre-TCJA laws, foreign profits do not face additional U.S. taxation (Pomerleau, 2018). The GILTI and FDII provisions work together as a carrot and stick to encourage operations from the U.S. and to prevent earnings derived from intangible income through CFCs. The two provisions provide a backstop to the new participation exemption and reduce incentives to shift corporate profits out of the U.S.; however, GILTI, the stick, is not a benefit. Instead, it is a deemed income inclusion when certain foreign income is earned through intangibles by a CFC, similar to Subpart F. GILTI discourages CFC intangible income by imputing current taxable income. Without GILTI, income earned through intangibles from CFCs would not be taxable in the U.S until repatriated and could have remained untaxed if it qualified for the participation exemption.

Under FDII, the carrot, however, a benefit through a deduction is given for income deemed to be generated using foreign intangibles. If the income qualifies, the U.S. corporation receives a lower tax rate on the FDII through a deduction, which incentivizes U.S. corporations to conduct global business operations from the United States. Singh and Mathur (2019) assert that FDII encourages U.S. corporations to own intangibles and export goods and services. Depending on the foreign tax rate, the FDII provision provides a real incentive for U.S. corporations to shift their intangible profits to be taxed in the U.S. The effective tax rate of 13.125% applicable to FDII can be considered relatively low compared to the corporate U.S. income tax rate of 21% and the average corporate tax rate of 23.7% in OECD countries.

GILTI AND FDII LIMITATIONS

According to Gravelle & Marples (2020), GILTI has been criticized for being too harsh and by some as not capturing enough income. One of the major concerns is that GILTI is "too harsh" with the foreign tax credit. TCJA retains the rules for allocating interest, research and development spending, and overhead to a narrowed GILTI foreign tax credit basket, which excludes certain foreign-source income, like royalties associated with domestic research and development. Thus, allocation of too many deductions to foreign-source income could result in GILTI at a higher rate than 13.125%. Additionally, there is no foreign tax credit carryback or carryforward. Any unused foreign tax credits are lost with no credits allowed for CFCs with losses.

Many critics also note that GILTI and FDII are not focused on intangible income but only on any residual income not associated with tangible property. Due to the calculation methods applied in determining the amount of GILTI and FDII, the provisions are also

expected to significantly impact the location of tangible investments (Fensby, 2018). This is because the calculation formulas do not take into consideration where the income derives from. Concerning both GILTI and FDII, the calculation is based on the deemed 10% return on QBAI, and the exceeding amount is deemed to be derived from intangibles. Thus, the location of tangible assets, the income derived from the tangibles, and the overall domestic and foreign income affect the final amount of FDII and GILTI. Essentially, GILTI captures excess profits unrelated to intangibles, which brings another argument that the deemed return on tangible income may be too high and fixed rather than variable because GILTI does not reflect inflation or variation in real interest rates (Gravelle & Marples, 2020).

CARES ACT EFFECT ON GILTI AND FDII

According to Gravelle (2020), the Coronavirus Aid, Relief, and Economic Security Act (CARES), included two general tax benefits for corporations, such as net operating losses (NOLs) and interest deductions which reduce taxable income and tax liability. These provisions affect existing international tax provisions enacted in TCJA. Under TCJA, when a firm has an NOL, taxes are not reduced immediately beyond zero. Instead, the corporation owes no income tax in that tax year, and the loss can be carried forward indefinitely to reduce up to 80% of taxable income in each taxable year.

CARES was enacted due to COVID-19, and it allows corporations to elect to carryback losses from years 2018 through 2020 for five years and also suspends the 80% of taxable income limit for years 2018-2020. Correspondingly, TCJA reduced the interest deduction cap to 30%. With CARES, the interest deductions limitations increase the cap to 50%.

GILTI and FDII deductions are limited to taxable income figured after all deductions, including NOLs and increased NOLs either through carryback provisions or by the 80% limit to taxable income. Gravelle (2020) emphasized that this can be detrimental to some corporations because they may cause the permanent loss of GILTI and FDII tax deductions and GILTI foreign tax credits, which cannot be carried forward by using NOLs that can be carried forward. Corporations, however, can opt-out of the NOL carrybacks and the increase in the interest deductions.

PRESIDENT JOE BIDEN'S TAX PROPOSALS

Brockman (2021) states that the Biden administration plans to reverse portions of TCJA. For U.S. corporations, one significant change is the Biden administration's plan to raise the corporate income tax rate from 21% to 28% (Brockman, 2021; Gleckman, 2021; Watson et al., 2020). The new administration also seeks to raise the GILTI tax from the current rate of 10.5% to 21%, assess GILTI on a country-by country basis, eliminate the 10% exemption of QBAI, and repeal the provision of FDII (Gleckman, 2021, Watson et al., 2021).

While these proposals seek to increase GILTI, the stick, and repeal FDII, the carrot, perceptions of these changes vary, focusing on different impacts of the proposed changes. "Higher GILTI burdens will incentivize large businesses to bring operations

back into the US for job growth, and it raises significant US tax revenue amid the economic fallout from the pandemic" (Mehboob, 2021). In a report by O'Neal, et al. (2021), two U.S. multinational companies were interviewed. Both companies stated that doubling the tax rate of GILTI would be penalizing companies that have operated internationally for years.

CONCLUSION

In 2017, the U.S. passed TCJA, which included two innovative international tax provisions called GILTI and FDII, to make U.S. corporations more competitive in the global market, encourage repatriation of foreign earnings, and encourage international businesses to expand operations within the U.S. Before TCJA, the U.S. tax laws permitted U.S. corporations to defer payments of U.S. tax on foreign income, but GILTI revoked this deferral approach. In TCJA, the current tax applicable to CFCs is paid immediately rather than later. Additionally, FDII provides a right to a deduction and a lower effective tax rate applicable to foreign-source intangible income of U.S. corporations.

The GILTI and FDII provisions provide U.S. corporations methods and calculations based on the assumption that some income was derived from intangibles. Though complicated to understand, the GILTI and FDII provisions continue to provide discussions about international business operations, and between them have created a carrot and a stick to encourage repatriation of earnings and increased investment in the U.S. It is prudent to take time to comprehend the GILTI and FDII provisions of TCJA; therefore, providing one with a basis on which to judge the proposals of the Biden administration. While those proposals are predicted to increase tax revenue for the U.S., it will be interesting to see how multinational companies respond to the larger stick, GILTI, and the smaller carrot, FDII.

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