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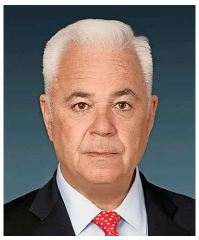
INSIGHT: GILTI Raises Issues With Downward Attribution and Compliance



BY JEREMY SWAN, JAMES M. ROBBINS, AND BRADLEY MAINGUY

As international tax law reform moves from rules into practice, U.S. multinational companies and private equity (PE) funds are working on the changes. That process has been complicated by unintended consequences. For example, when Congress repealed former tax code Section 958(b)(4) to target certain de-control transactions, it created problems with downward attribution in other situations. In addition, extensive reporting requirements have bulked up the compliance burden, especially for PE funds.

Understanding the GILTI Trajectory

The global intangible low-taxed income regime (GILTI) applies to 10% or more U.S. shareholders in controlled foreign corporations (CFCs)—entities in which these U.S. shareholders own more than 50% of the stock by vote or value. They are generally required to include in taxable income, whether or not distributed, their share of the net income (referred to as net tested income) of that CFC reduced by the return on tangible depreciable assets, which is currently 10%.

Before the IRS released final and proposed regulations in June 2019, if a U.S. partnership fund vehicle was used to acquire a controlling stake in a foreign corporation, that vehicle was considered a U.S. shareholder, and, as a consequence, GILTI was required to be allocated to its partners. If there were U.S. taxable partners in the domestic fund vehicle, they suddenly received income, whether or not there had been distributions from the foreign corporation. While rules requiring U.S. shareholders to include phantom income existed prior to tax reform (Subpart F rules), they were not as far-reaching as the GILTI rules.

When the IRS released the final and proposed regulations, it adopted a rule for domestic partnerships that would allow ''look through'' for purposes of determining GITLI inclusions. A similar rule had existed for foreign partnerships. So rather than considering partnerships to be U.S. shareholders, the IRS will look through the partnerships to U.S. partners that own 10% or more of the foreign corporation through their ownership of the fund vehicle and require those partners to include GILTI in taxable income. However, U.S. partners whose ownership stake is lower than 10% would not be subject to GILTI.

Why Downward Attribution Is a Problem

Downward attribution refers to attribution from a shareholder to a company it owns. For example, if you own 100% of a U.S. company and 100% of a foreign company, downward attribution would assign your shares in the foreign company to your U.S. company. So, for purposes of the CFC test, the U.S. company would be considered to own 100% of the foreign company.

Before its repeal, Section 958(b)(4) stated that an entity could not apply downward attribution to cause shares owned by a foreign company or a foreign person to be owned by a U.S. person. Congress removed this Section 958(b)(4) to target de-control transactions that would allow U.S. shareholders to potentially avoid Subpart F and GILTI provisions. As a result, downward attribution applies in determining whether a corporation is a CFC and if a shareholder is a 10% U.S. shareholder.

The change has created problems for many common PE structures. Consider a fund that owns controlling interests in various portfolio companies around the world as well as a U.S. company taxed as a corporation. Under downward attribution, all of the fund's foreign companies are attributed to its portfolio U.S. company. Now, even if only one U.S. shareholder has a 10% or more stake, all the companies are considered CFCs, and the U.S. shareholder is presented with burdensome filing obligations, as well as potential GILTI inclusions. This situation could arise, for example, if a foreign fund entity has an onshore U.S. feeder entity with greater than 10% ownership in the fund. While the new regulations provide for a look-through approach to domestic partnerships for purposes of the GILTI inclusion rules, the U.S. feeder will still be required to undertake burdensome compliance obligations with respect to the foreign corporations now classified as CFCs. In addition, any U.S. taxable investors in the fund may be subject to GILTI inclusions if their ownership in the CFCs through the fund entities equals 10% or more.

What Are the Options?

Rep. Kevin Brady (R. Texas) has released a technical correction discussion draft in the House of Representatives that would restore Section 958(b)(4). Under the proposed correction, downward attribution would apply only to ''foreign controlled U.S. shareholders,'' defined as greater than 50% U.S. shareholders, rather than 10% or greater U.S. shareholders. So, it would solve the problem for companies other than foreign controlled U.S. shareholders.

Despite the hurdles, GILTI offers a generous Section 250 deduction, currently 50% for U.S. corporations. For now, the effective rate for a U.S. corporation, even putting aside foreign taxes, is 10.5%. As long as a CFC is paying at least a 13.125% or higher rate overseas, the effective rate in the U.S. on GILTI is essentially zero.

Individuals who are subject to GILTI face a harsher situation. They are not eligible for the Section 250 deduction or the benefit of foreign taxes paid by the foreign corporation. However, Section 962 allows them to elect to be taxed on their GILTI as if they were a corporation so that they can get the deduction and the foreign tax credits, and greatly reduce their rate. Later distributions to individuals from CFCs out of GILTI earnings that exceed the actual tax paid would be subject to tax.

Start Early and Budget More

Compliance has been unusually burdensome because of requirements for more information about portfolio companies. Funds, especially those with a large portfolio of foreign entities, face extra pressure because of the volume of disclosure forms they file and footnotes they compile.

It's important to plan and budget accordingly. Companies will need more time and staff to handle the extra compliance and filing, and even the tax itself.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Jeremy Swan is a managing principal, Financial Sponsors & Financial Services Industry; James M. Robbins, JD, LLM, is a principal, and Bradley Mainguy is a senior manager, National Tax - International Tax at CohnReznick LLP.