

"Tax-Favored" Foreign Income: Planning Pointers and Traps

An Overview of the FDII and GILTI Deductions

Prepared by:
Morris N. Robinson, CPA, LLM
M. Robinson & Company, P.C.



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By Attorney Morris Robinson, CPA, LLM
(617) 428-6900

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An Overview of the FDII and GILTI Deductions

By Attorney Morris N. Robinson, CPA, LLM¹

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The Tax Cuts and Jobs Act (TCJA) reduces the corporate income tax rates of C corporations to 21 percent. The TCJA further reduces the C corporation income arising from tax-favored foreign income by means of two deductions:

- (1) The Foreign-Derived Intangible Income (FDII) deduction equals 37.5 percent of FDII and results in an effective C corporation tax rate of 13.125 percent² of FDII.
- (2) The Global Intangible Low-Taxed Income (GILTI) deduction equals 50 percent of GILTI and results in an effective C corporation rate of 10.5 percent³ of GILTI.⁴

What Is “Tax-Favored” FDII and GILTI?

There are two separate definitions of tax-favored foreign income: One definition (foreign-derived intangible income) is the “base” for the FDII deduction. The other definition (global intangible income) is the “base” for the GILTI deduction.

1. The FDII Definition of Foreign-Derived Income

The following definition of foreign-derived income, as adjusted,⁵ forms the “base” for the FDII deduction. Specifically,

- (1) The sale, rental, licensing and exchange of property can result in foreign-derived income if two criteria are met:
 - (a) The property is sold, leased, licensed or exchanged to a foreign buyer, that is, to a buyer who is NOT a citizen or resident of the United States, a domestic corporation, a domestic partnership, etc.; and
 - (b) The property is sold, leased, licensed or exchanged for a foreign use, that is, any use, consumption or disposition which is NOT within the United States.⁶
- (2) The sale of services gives rise to foreign-derived income if either (1) the recipient of the services is NOT located within the United States or (2) the property to which the services relate is NOT located within the United States.⁷

2. The GILTI Definition of Foreign-Global Income

Stripped of complications GILTI is income earned by a controlled foreign corporation, as adjusted,⁸ that is not effectively connected with the conduct of a trade or business in the United States.⁹

- **Observation:** Unlike the FDII deduction, there is no distinction between the sale of property or services. Also, the determination of foreign-global income does not turn on (1) the identity of the buyer; or (2) the final use, consumption or disposition of the product or service being sold outside the United States.
- **Observation:** Under new Section 250, the GILTI may be “grossed up” under Section 78 for deemed foreign tax credits if the C corporation makes an appropriate election.¹⁰

How Is the Tax-Favored Foreign Income Earned?

The FDII and GILTI deductions are not available to taxpayers other than C corporations. Therefore, these deductions are not available to individuals, pass-through entities, or fiduciaries. Only C corporations are entitled to FDII and GILTI deductions – and only if their foreign-derived income is earned in specific ways.

Observation:

Only C corporations are entitled to FDII and GILTI deductions – and only if their foreign-derived income is earned in specific ways.

- (1) The FDII deduction only applies when the foreign-derived income of the C corporation is earned in the United States. Income earned by a C corporation doing business through a foreign branch¹¹ is specifically excluded from the definition of foreign-derived income eligible for the FDII deduction.¹² Similarly, the deemed income of a CFC reported by a C corporation is excluded from the definition of FDII.¹³
- (2) The GILTI deduction only applies when foreign-derived income is earned by a controlled foreign corporation (CFC) whose business is not effectively connected with a trade or business located in the United States.¹⁴ Generally, a CFC is a corporation organized under the laws of a foreign country that is more than 50 percent owned by United States shareholders.¹⁵ Thus, the GILTI deduction does not apply to the foreign branch income of a C corporation.¹⁶

Avoiding Branch Income

As noted above, the branch income¹⁷ of C corporations does not qualify for either the FDII deduction or the GILTI deduction. Therefore, if it is appropriate for a C corporation to operate abroad, it should consider organizing as a CFC. This requires meeting three related tests:

- (1) The foreign entity must be treated as a corporation under foreign law;
- (2) The foreign entity must be a controlled foreign corporation within the meaning of Section 957(a); and
- (3) The C corporation must own at least 10 percent of the CFC.¹⁸

Taxes aside, it is usually best for a C corporation to do business abroad through a controlled foreign corporation. If the C corporation does business through a branch, the foreign jurisdiction may seek to audit the

United States income of the C corporation. In our experience, if the C corporation seeks to do business through a disregarded entity, the foreign jurisdiction may also seek to audit the C corporation's world-wide income.

- **Observation:** Companies operating abroad must make the appropriate disclosures to the Internal Revenue Service and the United States Treasury. These disclosures may include the (1) reporting of signature authority over foreign bank accounts;¹⁹ (2) reporting of ownership interests in foreign corporations;²⁰ and (3) reporting of ownership interests in foreign disregarded entities.²¹

Subcontractors Cannot Take Advantage of the FDII Deduction

If a subcontractor sells property to a contractor (other than a related party, discussed below) for further manufacture or other modification within the United States, the transaction does not give rise to foreign-derived income of the subcontractor even if the final buyer is not a U.S. person and the product is not subsequently used, consumed or disposed of within the United States.²²

If a subcontractor provides services to a contractor (other than a related party, discussed below) located within the United States, the subcontractor cannot receive foreign-derived income even if the ultimate recipient of the services is located outside the United States.²³

- **Observation:** The contractor cannot claim foreign-derived income arising from subcontracted services because Section 250(b)(4)(B) specifically requires that the “services [be] provided by the taxpayer.” At this point, the contractor is the “taxpayer” but the “services” were provided by the subcontractor.

Related Parties and the FDII Deduction

Generally, members of an affiliated group are treated as a single economic unit and must meet additional criteria before either (1) the sale, rental, licensing or exchange of property or (2) the sale of services can result in foreign-derived income.²⁴

How is the FDII Deduction Computed?

A slightly simplified outline of the FDII deduction computation follows:

- (1) Determine the foreign-derived income, described earlier, less related deductions excluding (1) Subpart F income; (2) dividends received from controlled foreign corporations; (3) income earned by foreign branches of the C corporation; and (4) other items of income listed in Section 250(b)(3)(A)(i).²⁵
- (2) Determine the gross income less related deductions of the C corporation, excluding (1) Subpart F income; (2) dividends received from controlled foreign corporations; (3) income earned by foreign branches of the C corporation; and (4) other items of income listed in Section 250(b)(3)(A)(i).
- (3) Reduce the net income, as computed in Item 2, above, by 10 percent of the C corporation's tangible assets subject to an allowance for depreciation. The result is called “Deemed Intangible Income.”

- (4) Prorate the Deemed Intangible Income (Item (3), above) by a ratio. The numerator of the ratio is the foreign-derived income less related deductions determined in Item (1), above. The denominator of the ratio is gross income less related deductions and exclusions as determined in Item (2), above. The product of the proration is foreign-derived intangible income or FDII.
- (5) The FDII deduction is presently 37.5 percent of FDII. The FDII deduction decreases to 21.875 percent of FDII for taxable years beginning after December 31, 2025.

How is the GILTI Deduction Computed?

A slightly simplified outline of the GILTI deduction computation follows:

- (1) Determine the gross income of the CFC, less related deductions, and excluding
(1) income effectively connected with the conduct of a trade or business in the United States; (2) Subpart F income; (4) other items of income listed in Section 951A(c)(2)(A)(i).
- (2) Reduce the net income, as computed in Item 2, above, by 10 percent of the C corporation's tangible assets subject to an allowance for depreciation.
- (3) Allocate the CFC's GILTI income to the C corporation.²⁶
- (4) The GILTI deduction is presently 50 percent of the C corporation's GILTI. The GILTI deduction percentage decreases to 37.5 percent of GILTI for taxable years beginning after December 31, 2025.

Defending the FDII and GILTI Deductions in Tax Audits

By the time the FDII deduction is audited, several years may have passed. Accounting personnel may have changed and the company itself may have been sold. Thus, it is important to prepare for the defense of FDII and GILTI deductions well before the audit notice comes.

Observation:

It is important to prepare for the defense of FDII and GILTI deductions well before the audit notice comes.

1. The Tax-Audit Defense of the FDII Deduction

The tax-audit defense of the FDII deduction requires the *timely* assembly of the following information:

- (1) The identity and location of the foreign buyer.
- (2) The identity and description of the property sold to the foreign buyer.
- (3) The anticipated foreign use, consumption or disposition of the above property. If the property sold is a component, such as an automobile part, care is needed to document exactly where the final product (e.g., the automobile) will be used, consumed or disposed.
- (4) A description of the services giving rise to foreign-derived income.

(continued)

- (5) A description of the location of the foreign buyer of the services and/or the location of property to which the above-described services relate.
- (6) The identity and involvement of all domestic intermediaries (subcontractors) and related parties in the manufacture of the product or the provision of the services.

2. **The Tax-Audit Defense of the GILTI Deduction**

Generally, it should be easier to defend the GILTI deduction. Specifically, the tax-audit defense of the GILTI deduction only requires proof that:

- (1) The CFC is incorporated in a foreign country as a foreign corporation.
- (2) The CFC does not operate in the United States and its business is NOT effectively connected with the conduct of a trade or business in the United States.
- (3) The CFC meets the statutory requirements of a CFC. Namely, that United States shareholders own more than 50 percent of the CFC.
- (4) The transfer price for goods and services between the C corporation and the CFC is reasonable.²⁷

Should Taxpayers Convert To C Corporations To Take Advantage of the FDII Deduction?²⁸

Should taxpayers convert to C corporations to take advantage of the FDII deduction? As noted above, the FDII deduction reduces the effective tax rate on a C corporation's FDII from 21 percent to 13.125 percent and the effective tax rate of the corporation's GILTI from 21 percent to 10.50 percent. But tax advisors must also ask: What is the effective tax rate of foreign-derived income earned by C corporations and their shareholders? This analysis is complicated due to the complex rules governing the taxation of C

corporation dividends and the double taxation of gains arising from the sale of C corporation assets.

Observation:

The FDII deduction reduces the effective tax rate on a C corporation's FDII from 21 percent to 13.125 percent and the effective tax rate of the corporation's GILTI from 21 percent to 10.50 percent.

United States citizens and residents pay United States income taxes on the dividends of domestic C corporations at capital gains rates. There are three capital gains rates based on the tax bracket of the shareholder: 20 percent; 15 percent and 0 percent. Thus, the amount of income taxes paid by a shareholder on C corporation dividends varies between \$173.75 and zero. See Table of Shareholder's Income Tax in Appendix.

Dividends are also subject to a net investment income tax of 3.8 percent ("NIIT"). The NIIT, however, does not apply to taxpayers whose taxable income of a taxpayer falls below \$250,000 for married couples filing joint income tax returns; \$125,000 for married couples filing separately; and \$200,000 for all other taxpayers.²⁹ Thus, the amount of net investment income taxes paid by a shareholder on C corporation varies between \$33.01³⁰ and zero.

(continued)

Thus, the maximum United States income tax rate on foreign-derived income varies between 33.8 percent and 13.125 percent of FDII, as follows:

	20 percent CG Rate	15 Percent CG Rate	0 Percent CG Rate
Corporate-Level Income Tax on \$1,000 of FDII – Footnote 1	\$131.25	\$131.25	\$131.25
Shareholder-Level Income Tax On \$1,000 of FDII - Appendix	173.75	130.31	0.00
Net Investment Income Tax (3.8 percent of \$868.75 ³¹)	<u>33.01</u>	<u>33.01</u>	<u>0.00</u>
Total Taxes on \$1,000 of FDII	<u>\$338.01</u>	<u>\$294.57</u>	<u>131.25</u>
Effective Combined Tax Rate (Total Taxes / \$1,000)	<u>33.801%</u>	<u>29.457%</u>	<u>13.125%</u>

What are the potential combined income tax savings arising from the use of a C corporation? It is not always clear if there are significant potential tax savings arising. For example, at the highest individual bracket the potential combined income tax savings is only \$32 per \$1,000 of foreign-derived income, as follows:

Maximum U.S. Income Tax Rate On Foreign-Derived Income of Individuals and Fiduciaries	37.0 %
Maximum Effective U.S. Income Tax Rate On Foreign-Derived Income of C Corporations and their Owners - Above	<u>(33.8)</u>
Tax Rate Reduction	<u>3.2 %</u>

This modest tax benefit may be offset by the possible double taxation of gains arising from the sale of C corporation assets upon the sale of the business.³²

Conclusion: The Need to “Run the Numbers”

As noted above, the effective combined income tax rates for a C corporation and its shareholders vary between 33.801 percent; 29.457 percent; and 13.135 percent. Also, the tax rate reduction – even at the highest bracket – might be as little as 3.2 percent before considering the double taxation of possible gains arising from the sale of C corporation assets. Thus, it is best to always “run the numbers” and confirm that the anticipated tax savings will outweigh the time, effort, distraction and money involved in converting a taxpayer with FDII to a C corporation.

(Continued on next page.)

Appendix:
Table of Shareholder's Income Tax
At Capital Gains Rates

CG Rate	20 percent CG Rate	15 Percent CG Rate	0 Percent
Foreign-Derived Intangible Income	\$1,000.00	\$1,000.00	\$1,000.00
Less: C Corporation Income Tax - Above	<u>(131.25)</u>	<u>(131.25)</u>	<u>(131.25)</u>
Foreign-Derived Intangible Income Available for Dividends	\$ 868.75	\$868.75	\$868.75
Maximum Capital Gains Rates on Dividends from Domestic Corporations	<u>20 %</u>	<u>15%</u>	<u>0%</u>
Shareholder's Income Tax (20 percent of \$868.75)	\$ <u>173.75</u>		
(15 percent of \$868.75)		\$ <u>130.31</u>	
(0 percent of \$868.75)			\$ <u>0.00</u>

Endnotes

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¹ Attorney Morris N. Robinson, CPA, LLM is Managing Director of M. Robinson Tax Law, a tax law firm boutique located in Boston's Financial District. His practice emphasizes tax planning, tax audit defense, and tax compliance for businesses and individuals. He acknowledges the invaluable assistance of Joseph Kelley, Paralegal.

² 21 percent of [100 less 37.5 percent] equals 13.125 percent. The FDII deduction percentage decreases from 37.5 percent to 21.875 percent of FDII for taxable years beginning after December 31, 2025. See Section 250(a)(3).

³ 21 percent of [100 less 50.0 percent] equals 10.5 percent. The GILTI deduction percentage decreases from 50 percent to 37.5 percent of GILTI for taxable years beginning after December 31, 2025. See Section 250(a)(3).

⁴ The United States foreign tax credit can reduce the actual effective tax rate on GILTI to zero. 80 percent of foreign income taxes on GILTI are allowed as a foreign tax credit. See Section 960(d)(1). GILTI represents a separate "basket" of foreign-source income for purposes of the United States foreign tax credit. See Section 904(d)(1)(A). Excess foreign income taxes on GILTI cannot be carried back or carried over. Section 904(c)(last sentence). Thus, if the foreign income taxes allocable to GILTI exceeds 10.5 percent of GILTI, those foreign income taxes may never be credited against the U.S. tax. See, generally, Economic Analysis: More GILTI Than You Thought by Martin A Sullivan posted February 13, 2018. <https://www.taxnotes.com/tax-reform/economic-analysis-more-gilti-you-thought> (last visited May 23, 2018).

⁵ See **How is the FDII Deduction Computed**, below.

⁶ Section 250(b)(4) and (b)(5)(A) and (B).

⁷ Id.

⁸ See **How is the GILTI Deduction Computed**, below.

⁹ Section 951A(c)(2)(A)(i)(I).

¹⁰ Section 250(a)(1)(B)(ii).

¹¹ Section 904(d)(2)(J), which provides (generally): “The term ‘foreign branch income’ means the business profits of such United States person which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries. ... Such term shall not include any income which is passive category income.”

¹² Section 250(b)(3)(A)(vi) and Section 904(d)(2)(J).

¹³ Section 250(b)(3)(A)(iv).

¹⁴ Section 951A(c)(2)(A)(i)(I).

¹⁵ Section 957(a). Generally, a United States Shareholder is defined in Section 951(b) as a U.S. person who owns 10 percent or more of a foreign corporation.

¹⁶ Since GILTI is based on the deemed income of a CFC.

¹⁷ See Footnote 8, above.

¹⁸ Section 951(b).

¹⁹ See instructions to FinCEN Form 114.

²⁰ See instructions to Form 5471.

²¹ See instructions to Form 8858.

²² Section 250(b)(5)(B)(i).

²³ Section 250(b)(5)(B)(ii).

²⁴ See McDermott, Will and Emery’s blog dated January 24, 2018 <https://www.mwe.com/en/thought-leadership/publications/2018/01/the-new-deduction-for-foreign-derived-intangible> (last visited May 10, 2018)

²⁵ Only “deduction eligible income” is included in the FDII computation. See Section 250(b)(4).

²⁶ Section 951A(e)(1). This assumes that the C corporation owns at least 10 percent of the value or voting power of the CFC.

²⁷ Section 482.

²⁸ As noted above, it is usually best for a C corporation to operate abroad through a controlled foreign corporation. See **Avoiding Branch Income**, above.

²⁹ Section 1411(b).

³⁰ 3.8 percent of \$868.75. See **Table of Shareholder’s Income Tax** in Appendix.

³¹ See **Table of Shareholder’s Income Tax** in Appendix.

³² It is not always possible to avoid the double tax by making an S election due to the 5-year lookback on built-in gains of S corporations. See Section 1374.

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