Trading Tangible for Intangible: The Incentives Created by GILTI and FDII in the TCJA

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Introduction

The recent Tax Cuts and Jobs Act (TCJA) contains two key international tax provisions: the tax on Global Intangible Low-Taxed Income (GILTI) and the reduced tax rate on Foreign Derived Intangible Income (FDII). These provisions were designed to encourage United States-based multinationals to locate *intangible* intellectual property in the U.S. rather than in foreign jurisdictions. However, an aspect that is overlooked is that these same provisions also create incentives for U.S. firms to acquire *tangible* assets abroad and to sell tangible assets in the United States. Future monitoring of these activities is required to assess the extent to which U.S. multinationals will shift production overseas in response to the incentives created by GILTI and FDII.

Moving to a Territorial Tax

The TCJA moved the U.S. from a “worldwide” system of taxation toward a more “territorial” system. Under the worldwide tax system, U.S. corporations were taxed on income regardless of whether it was earned in the U.S. or abroad. If the income was earned abroad, the corporation paid tax on the income when it was “repatriated.” Under the territorial system, corporations are taxed only on U.S. income, making foreign income exempt from tax.

As noted in our recent blog post, U.S. corporations have accumulated as much as $2.8 trillion in untaxed profits in foreign subsidiaries prior to the passage of the TCJA. These profits would have been untaxed under the new territorial system. In order to prevent this base erosion, the TCJA, therefore, also imposes a “deemed repatriation” on those past earnings, but at a reduced tax rate. However, “deemed repatriation” only applies to *past* earnings. The GILTI and FDII provisions are intended to deal with future earnings by reducing the incentive of U.S. corporations to shift intellectual property abroad.

The GILTI Tax

The corporate rate reduction (35 percent to 21 percent) diminished incentives for corporations to accumulate offshore earnings. However, the transition to a territorial system could leave untaxed earnings permanently offshore, thus eroding the U.S. tax base. The intention of GILTI is to tax future foreign earnings to reduce this potential base erosion. The GILTI provision levies a tax on the income of a U.S. multinational corporation’s (MNC) foreign affiliates *net* of a presumptive 10 percent return on tangible assets. Generally, the formula for GILTI is:

$$\text{GILTI} = (\text{Sum of CFC Tested Income} - \text{Sum of CFC Tested Loss}) - [(10\% \times QBAI_F) - \text{Interest Expense}]$$

where the tested income of a controlled foreign corporation (CFC) is what is left of the CFC’s gross income after certain exclusions and deductions (including taxes) are applied.[1] If the calculated tested income of a CFC is negative it is considered to be tested loss. $QBAI_F$ or the “Qualified Business Asset Investment” is the aggregate of a CFC’s adjusted basis in specified tangible property used in its trade or business.

Since it is imposed on an immediate basis, GILTI does not have an impact on the accumulation of earnings abroad. With the new 21 percent corporate rate effective for taxable years beginning after December 31, 2017 and a 50 percent deduction, GILTI is taxed at 10.5 percent.[2] Holding everything else constant, though, an increase in $QBAI_F$ decreases GILTI.[3] It is therefore beneficial for U.S. multinational corporations to acquire foreign tangible assets in order to reduce their GILTI tax.[4] For example, by expanding production facilities abroad Harley-Davidson not only avoids tariffs imposed by the EU, it also reduces its overall U.S. tax liability.

The FDII Provision

The FDII concept establishes a type of income that is subject to a preferential rate (13.125 percent[5]) and acts as an export subsidy. The amount of a corporation's income eligible for the preferential rate depends on the share of its income derived from foreign markets, net of a 10 percent return on tangible U.S. assets. The formula is as follows:

$$\text{FDII} = (\text{Deduction Eligible Income} - 10\% \times QBAI_{US}) \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

where Deduction Eligible Income and $QBAI_{US}$ can be thought of as the domestic analogs to CFC tested income and $QBAI_F$ respectively (described above). Holding everything else constant, a decrease in $QBAI_{US}$ increases FDII.[6] Consequently, U.S. corporations have an incentive to sell their domestic tangible assets in order to increase the amount of income subject to the lower tax rate.

Discussion

Currently, there is no international tax system that resembles the system established by the TCJA. As such, it is difficult to determine the consequences of this incentive. However, Altshuler and Grubert (2010)[7] present simulation results of a move to a formula apportionment system that is not unlike the move under the TCJA. The results suggest that tangible capital decreases in the home country but increases in low-tax foreign countries under a formula apportionment system.

Additional Incentives

The reform of the U.S. international tax rules laid out in the TCJA is likely to have many consequences, beyond the incentives to acquire foreign tangible assets and sell U.S. tangible assets discussed above.

Since GILTI is calculated on an aggregated basis over all of a U.S. multinational corporation's CFCs, it also creates an incentive for multinational corporations to shift profits out of the U.S. and blend income from low-tax foreign countries with that from higher-tax foreign countries to lower its overall tax burden. Only 80 percent of foreign tax credits are allowed to offset U.S. tax on GILTI. Therefore, if the blended tax rate faced by a multinational corporation is higher than 13.125 percent, then its GILTI tax liability is zero.[8]

The GILTI has a heterogeneous impact on U.S. multinational corporations. It increases the tax burden faced by any multinational corporation that deferred foreign earnings, especially those who previously deferred indefinitely. However, it is less onerous to multinational corporations that operate in industries where normal rates of return below 10 percent are the norm.[9]

Finally, since companies that produce goods abroad are not taxed on the normal return of their tangible assets and the GILTI tax is so low compared with the corporate rate of 21 percent, the new rules could potentially encourage production to be shipped offshore.[10]

Future Monitoring

GILTI and FDII are complicated provisions and a lot of details have not been touched on. In the near future, we will also look into the outcomes of international tax competition as countries race to lower corporate taxes in the hope of attracting investment.

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1. Please see page 510 of "Joint Explanation Statement of The Committee of Conference", for the exceptions to tested income. ↩
2. For taxable years beginning after December 31, 2025, the deduction for GILTI is lowered to 37.5 percent, and therefore, the GILTI rate will increase to 13.125 percent. ↩
3. Additional foreign tangible assets can generate income and drive up the net CFC tested income. However, assuming the standard return on tangible assets and considering the exclusions and deductions, we would still expect GILTI to decrease as a result. ↩
4. A few articles reach the same conclusion. See "The Consequences of the TCJA's International Provisions: Lessons from Existing Research" by Dhammika Dharmapala, "Current Tax Reform Bills Could Encourage US Jobs, Factories and Profits to Shift Overseas" by Steven Rosenthal, "Tax Reform and the Trade Balance" by Brad Setser and "The Games They Will Play: Tax Games, Roadblocks, and Glitches Under The 2017 Tax Legislation" by David Kamin, et al. ↩
5. With the new 21 percent corporate rate effective for taxable years beginning after December 31, 2017 and a 37.5 percent deduction, FDII is taxed at 13.125 percent. For taxable years beginning after December 31, 2025, the deduction for FDII is lowered to 21.875 percent, and therefore, the FDII rate will increase to 16.406 percent. ↩
6. Lowering the amount of U.S. tangible assets can decrease deduction eligible income. However, assuming the standard return on tangible assets and considering the exclusions and deductions, we would still expect FDII to increase as a result. ↩
7. Altshuler, Rosanne, and Harry Grubert. "FORMULA APPORTIONMENT: IS IT BETTER THAN THE CURRENT SYSTEM AND ARE THERE BETTER ALTERNATIVES?" *National Tax Journal*, n.d., 40. ↩
8. See the discussion on the global minimum tax in Gene Sperling's article "How Trump's Corporate-Tax Plan Could Send American Jobs Overseas." ↩
9. See Hogan Lovells (2018), "Cross-Border Provisions of Tax Cuts and Jobs Act: Implications and Planning Considerations." ↩
10. See the report "Tax Law May Send Factories and Jobs Abroad, Critics Say" by Natalie Kitroeff in the New York Times. ↩