NALSAR

Global Intangible Low Taxed Income ('GILTI')

Key highlights

October 2022

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Overview of US Tax Reforms

US Tax law reforms

- **Reduction in Corporate tax rate** - The Act reduces the corporate tax rate to a flat rate of 21% with effect from 1 January 2018, doing away with the graduated corporate structure.

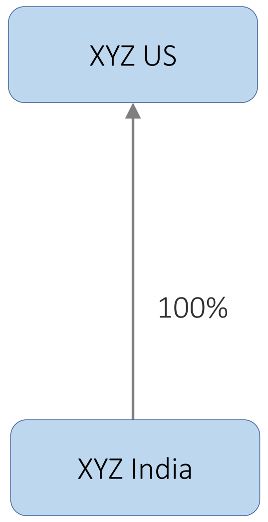
- **Elimination of Alternate Minimum Tax (AMT)** - The corporate AMT will be eliminated, with an expanded utilization (and potential refundability) of existing AMT credits for years beginning before 2021.

- **Modification of the net operating loss (NOL) deduction** - NOL carry back period is eliminated (as opposed to 2 years in the current law), and NOL carry forward period is extended indefinitely (as opposed to 20 years in the current law). However, the NOL deduction allowed would be limited to 80% of taxable income computed without regard to the NOL deduction.

- **Limitation on business interest** – The Act changes to the limitation on interest deductibility for taxpayers (barring certain small businesses), limiting the deduction to business interest income plus 30% of the taxpayer's EBITDA through 2021 and 30% of EBIT thereafter. In the case of a group of affiliated corporations that file a consolidated return, the Act clarifies that the limitation applies at the consolidated tax return filing level as opposed to an entity level.

- **Treatment of self-created property** - the gain or loss from the sale of a self-created patent, invention, model or design, or secret formula or process will not receive capital gain treatment. This provision is effective for disposition of such property after 2017.

Corporate tax rate @ 21%*
AMT @ Nil



* Section 199 manufacturing deduction is repealed (9% deduction for domestic US manufacturing income).

BEAT and GILTI

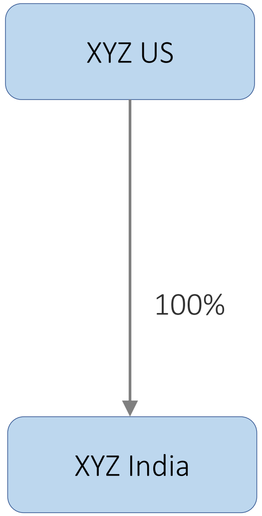
US Tax law reforms - BEAT

- **Base Erosion Anti-Abuse Tax (BEAT)** -
  - BEAT is imposed on certain corporations ("applicable taxpayer") making payments to related foreign persons i.e., base erosion payment. The purpose of the BEAT is to identify and impose a special tax on entities that make payments to affiliates that substantially reduce U.S. taxable income
  - Such applicable taxpayer liable to Base Erosion Minimum Tax Amount ("BEMTA") equal to the excess of **10%** of "Modified Taxable Income" ("MTI" i.e., Taxable income without the benefit of related-party tax deductions) over the Regular tax liability ("RTL") reduced by certain credits

Financial Year	Taxpayers generally	Banks and securities dealers
2018	5%	6%
after 2018 before 2024	**10%**	11%
after 2025	12.5%	13.5%

  - Applicable taxpayer:
    - The taxpayer must be a corporation (that is not a regulated investment company, a real estate investment trust, or an S corporation) with an average annual gross receipts of at least $500 million over the three-year period ending with the preceding tax year
    - The taxpayer's "base erosion percentage" must be at least 3% (2% for certain banks and securities dealers) i.e., Ratio of deductible payments made to related parties and all deductible payments

Corporate tax rate @ 21%
AMT @ Nil

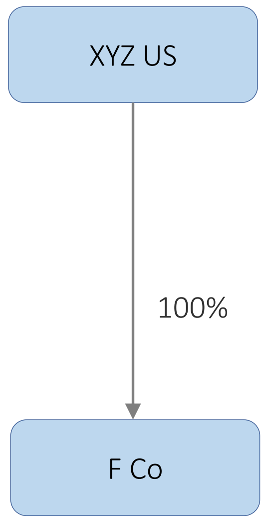


Refer Annexure 1 for Illustration on BEAT

US Tax law reforms - GILTI (Sec 951A)

- **Global Intangible Low-Taxed Income (GILTI) - Reason for Introduction**
  - Income earned by the foreign subsidiaries of U.S. corporations was subject to tax only when repatriated to the United States as dividends.
  - The Tax Cuts and Jobs Act (TCJA) changed the tax rules for multinational corporations by generally exempting the earnings of foreign subsidiaries' active businesses from U.S. corporate taxation, even if repatriated.
  - Although the TCJA lowered the top corporate income tax from a rate of 35% to a flat 21% effective in 2018, the U.S. corporate tax rate still exceeded the rate in some tax heaven countries (viz., Jersey, Guernsey, and the Isle of Man etc.)*
  - Situating ownership of a profitable patent, for example, in a foreign subsidiary in a lower-rate or no-tax jurisdiction instead of in the U.S. still could produce a substantial tax savings for MNEs.
  - Because of concerns that multinationals might seek to move profits abroad to escape the U.S. tax, the TCJA included provisions, particularly the tax on GILTI, to discourage such tax avoidance strategies.

Corporate tax rate @ 21%
AMT @ Nil

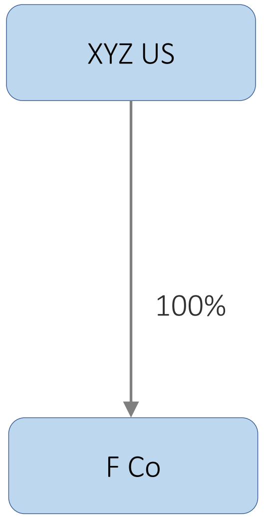


* These countries generally impose no corporate tax at all with only a few low-rate exceptions for certain financial services, natural resource and real estate income.

US Tax law reforms - GILTI

- **Global Intangible Low-Taxed Income (GILTI) - How it works?**
  - A new basket of subpart F income that applies to all CFCs. Refer **Annexure 2**
  - GILTI is income earned abroad by controlled CFCs (i.e., controlled subsidiaries of U.S. corporations) from easily movable intangible assets, such as IP rights.
  - CFCs are foreign corporations in which more than 50% of the vote or value is owned by U.S. shareholders who each own 10% or more of the CFC. In other words, CFC shareholders who own 10% or more of a CFC are liable for the tax on GILTI
  - GILTI = [CFC’s total income - 10% of Depreciable assets of CFC* - interest expense]
  - GILTI Tax base = 50% of GILTI#; On which 21% tax rate would be applied
  - And credit for FTCs is available (at 80%).

Corporate tax rate @ 21%
AMT @ Nil



* 10% of Depreciable assets is deemed to be tangible income return. In other words, The provision operates by attributing 90% return towards the intangible assets of the CFC and then taxing it in the hands of the US shareholder. GILTI is taxed on a shareholder-by-shareholder basis after aggregating the income of the CFCs owned by that shareholder

\# A deemed deduction of 50% is applied to GILTI limited to taxable income, from 2018 to 2025, and 37.5 percent starting in 2026.

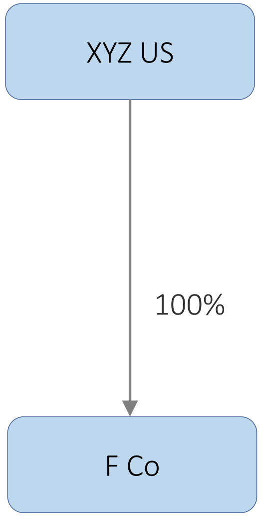
US Tax law reforms - GILTI

- **Global Intangible Low-Taxed Income (GILTI) - Illustration**

#	Particulars	Description	Amount (USD)
A	GILTI	USD 200 - 10% of 100 - Nil	190.00
B	GILTI Tax base	50% of USD 190	95.00
C	US Tax payable on GILTI Tax base	21% of USD 95	19.95

#	Particulars	Description	Amount (USD)
D	GILTI Tax base	50% of USD 190	95.00
E	Expense allocation for FTC*		40.00
F	Deemed foreign income		55.00
G	Deemed paid FTC	80% of USD 20	16.00
H	FTC Limitation	21% of USD 55	11.55
I	Eligible FTC	Min of G and H	11.55
J	**Residual US tax payable**	**C-I**	**8.40**

Corporate tax rate @ 21%
AMT @ Nil



Corporate tax rate @ 10%
Income earned - USD 200
Tax paid @10% - USD 20

Note: Depreciable assets - USD 100

Effective tax rate = (20+8.4)/200 = 14.20%

* The FTC rules require some US expenses to be allocated to the foreign income. Let’s say USD 40 in this Illustration

US Tax law reforms - GILTI

- GILTI high-tax exception rule

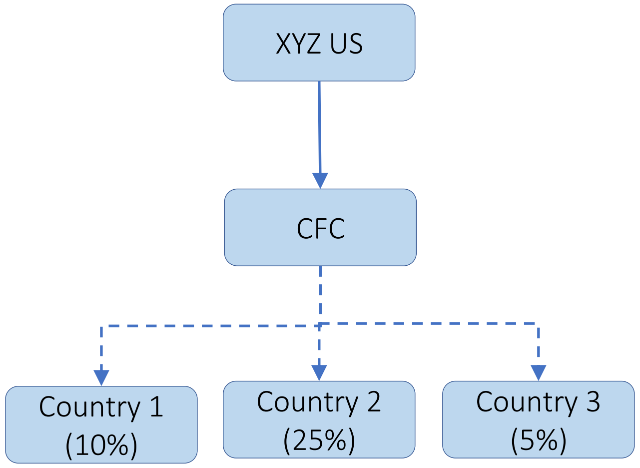
  - Taxpayers to elect a "high-tax exception" that would exclude from a US shareholder's GILTI inclusion items of income of its CFCs that would otherwise be part of the GILTI inclusion.

  - The exception would apply if the items are subject to foreign income tax at an effective rate that is greater than 90% of the maximum income tax rate under Section 11 (currently 21%, so a foreign effective tax rate greater than **18.9%**).

  - This GILTI high-tax exception would apply to each item of income at the level of each qualified business unit (QBU) of a CFC (for this purpose, items of income within each Section 904(d) limitation at the QBU level would be treated as a single item of income).

  - For example, assume a CFC wholly owns three foreign disregarded entities: DRE1 is subject to a 10% local tax rate, DRE2 is subject to a 25% local tax rate, and DRE3 is subject to a 5% local tax rate. In this case, the CFC would have four QBUs, with the CFC being deemed a QBU under Section 989, and the GILTI high-tax exception would apply separately to each QBU (with only DRE2's items of income likely excluded from the relevant US shareholder's GILTI inclusion).

  - Further, any foreign income taxes paid or accrued with respect to a CFC's items of income that are excluded from a US shareholder's GILTI inclusion under the GILTI high-tax exception would not be deemed paid under Section 960(d).



Refer Annexure 3 for explanation on GILTI in case of Multiple CFCs

Proposed changes - Build Back Better Act (BBBA)

- Changes proposed
  - The Budget would raise the corporate tax rate to 28%
  - The House bill would introduce a new 15% corporate alternative minimum tax (Corporate AMT) on the "adjusted financial statement income" of certain large corporations (very generally, and described in greater detail below, corporations reporting at least $1 billion average adjusted pre-tax net income on their consolidated financial statements), for tax years beginning after December 31, 2022.
  - Create a new general business credit equal to 10% of eligible expenses incurred when onshoring a trade or business to the United States
  - Disallow deductions for expenses incurred when moving a US trade or business offshore
  - The Budget would repeal the BEAT and replace it with a UTPR that is consistent with the Pillar Two Model Rules, which include the UTPR and the Income Inclusion Rule (IIR). Refer **Annexure 4**
  - The House bill would reduce the amount of the section 250 deduction to 28.5% (from 50%) of GILTI which would make the effective tax rate on GILTI to 20%[#].

[#] (100-28.50)*28% = 20%

Proposed changes - Interplay of GILTI and BEPS 2.0

- Pillar One of the OECD initiative would provide a new taxing right to market jurisdictions that would go beyond the arm's-length principle and permanent establishment standard.
- Pillar Two proposes to implement a global minimum taxation regime that is intended to ensure that all internationally operating businesses pay at least a minimum level of tax on their income in each jurisdiction regardless of where they are headquartered or the jurisdictions in which they operate.
- Applicability of GILTI and Pillar Two in case of U.S. sandwich structures i.e., when a non-U.S. ultimate parent owns a U.S. subsidiary, which itself owns a non-U.S. subsidiary ?
  - Under the Pillar Two top-down approach, intermediate parent jurisdictions are required to defer the application of their IIRs to the ultimate parent jurisdiction's IIR.
  - Thus, in a U.S. sandwich structure, the IIR would dictate that GILTI should not apply if the ultimate parent jurisdiction has adopted an IIR. The House bill GILTI proposal does not adopt this approach, but it does provide regulatory authority to allow a credit against U.S. tax for foreign taxes paid in the ultimate parent jurisdiction in a U.S. sandwich structure.

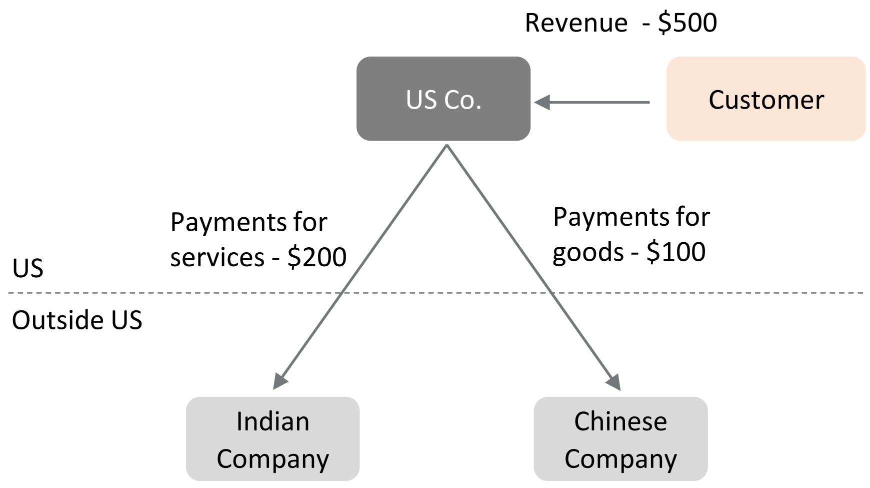
Annexures

Annexure 1 - Illustration on BEAT

- Base erosion payments can be deductible payments such as interest, royalties, or service payments. In this case, payments to Indian Company (USD 200)
- Base erosion percentage = 200/350*100 = 57.1% (i.e., >3%)
- Base Erosion Minimum Tax Amount (BEMTA) = 10% of Modified Taxable Income (MTI) - Regular Tax Liability (RTL)

#	Computation of RTL (Regular Tax Liability)	Amount (USD)
A	Gross Income	500
B	Deductions (200+100+50)	350
C	Taxable Income	150
D	Corporate Tax @ 21%	31.50

#	Computation of Modified Taxable Income	Amount (USD)
A	Gross Income	500
B	Deductions (100+50)	150
C	Modified Taxable Income	350
D	BEMTA = 10%(350)-31.50	3.50



For purposes of the BEAT computation, assume that:

1. US Co has $50 of other deductible costs with 3rd parties;
2. US Co qualifies as an Applicable Taxpayer; and
3. The $200 payment for services by US Co to Indian CFC is a payment for which a deduction is allowed in the taxable year.

Annexure 1 - Impact of BEAT on Indian entities

- This could have a significant impact for US companies which have set-up GIC's/captives/ back-offices in India (depending on their structure) since these companies will now have to pay an additional tax on the US income
- This could also result in an overall increase in the group tax costs and dilute some of the cost benefits which these US companies obtain by setting-up India GIC's/captives/ back-offices
- More relevant for Indian MNCs with US businesses, which pay back most of the income to India in the form of royalties / fees
- Risk of economic double taxation, FTCs cannot shelter BEAT liability

Annexure 2 - CFCs

- Controlled foreign corporations, or CFCs, are entities that are directly or indirectly more than 50% controlled by a U.S. parent but organized under foreign law. For U.S. income tax purposes, they are treated as corporations. CFCs typically do not have U.S. operations.
- Since the Revenue Act of 1962, which refined the definition of a CFC, Subpart F of the Tax Code has required Subpart F income (made up of mainly passive income) to be included in the current-year taxable income of a CFC’s United States shareholder, whether or not the CFC distributes that income to the shareholder in the current year.
- The dividends received deduction (DRD) under Sec. 245A offsets the U.S. impact of any foreign dividends from CFCs. This DRD is sometimes referred to as the “exempt basket.”
- Today, CFCs are still subject to the Subpart F rules, but the global intangible low-taxed income (GILTI) and the Base Erosion and Anti-abuse Tax (BEAT) regimes expand the range of situations where U.S. tax may be imposed on some or all of the earnings of a U.S. corporation’s CFC’s operations.

Annexure 3 - GILTI

Present:

- Under current law, a U.S. shareholder has a single GILTI inclusion computed on an aggregate basis across all of its CFCs. A US. shareholder's pro rata share of the aggregate of its CFCs' tested income is reduced by its pro rata share of the aggregate of its CFCs' tested losses to compute its net CFC tested income.
- Additionally, in determining its GILTI inclusion, the shareholder's net CFC tested income is reduced by its net deemed tangible income return. That net deemed tangible income return is 10% of a CFC's QBAI, reduced generally by the excess of certain interest expense over certain interest income taken into account in determining net CFC tested income.

Proposed:

- The proposal would require U.S. shareholders to compute GILTI inclusions and associated foreign tax credits on a country-by-country basis.
- To achieve this result, the proposal generally would determine tested income, tested loss, net deemed tangible income return, and foreign taxes for each "CFC taxable unit", and then aggregate these items for the CFC taxable units within the same country to determine separate GILTI inclusions for each country
- The proposal's country-by-country approach for determining GILTI would prevent tested losses incurred in one country from reducing tested income earned in another country.
- Consequently, taxpayers would benefit currently from a tested loss incurred within a particular country only to the extent a CFC taxable unit elsewhere in the structure has offsetting tested income earned within the same country.

Annexure 3 - GILTI & FDII

The two regimes use very different statutory schemes:

- The **FDII and GILTI** regimes are an attempt by Congress to use tax reform to encourage U.S. multinational corporations (USMNC) to increase their investments in the US. The intent appears to have been to favor structures where a USMNC holds its high-return, foreign-income-producing assets and operations in the US. over placing those assets and operations in overseas subsidiaries.
- In the case of **GILTI**, U.S. shareholders of controlled foreign corporations (CFCs) include in income (in a manner similar to the inclusion of subpart F income) the excess of the CFC's "tested income" over the shareholder's share of the deemed tangible income return of its CFC.
- On the other hand, **FDII** allows a domestic corporation a deduction of 37.5% of the excess of the corporation's income from export sales over a fixed return on its tangible depreciable assets for the year.

Annexure 4 - BEPS 2.0 - Four measures for global minimum taxation

	Parent/Residence jurisdiction	Source jurisdiction
Domestic legislation	**Income Inclusion Rule (IIR)** (2) Inclusion of the income of a low-taxed constituent entity in the tax base of the ultimate parent entity if that income is not taxed at the minimum 15% ETR.	**Undertaxed Payments Rule (UTPR)** (3) Secondary rule which is meant as a backstop in case the minimum taxation is not achieved through the IIR. The UTPR is applied by the jurisdiction of the payer.
Tax treaties	**Switch-over Rule (SOR)** Ensuring proper application IIR by allowing a switch from the exemption method to the credit method.	**Subject to Tax Rule (STTR)** (1) Additional source taxation (withholding) and deny treaty benefits for "mobile payments" (interest, royalties, etc.) not sufficiently taxed in the recipient's jurisdiction (<9% nominal rate).

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