The GILTI Regime and the Changing Face of U.S. Tax Rules

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In 2017, the U.S. Congress enacted landmark tax legislation known informally as the Tax Cuts and Jobs Act. One of the goals was moving the United States toward a pure “territorial” tax system, in which only corporate profits earned inside the U.S. are taxed internally and all of those earned outside are taxed in their respective countries.

However, the goal of pursuing a pure territorial tax system was tempered by Congress’s fear that multinationals would find ways to artificially shift U.S. profits to low-tax countries—otherwise known as “base erosion.” The fear was most acute with respect to profits tied to intellectual property.

GILTI

To address this fear, and to indirectly try to stem the offshoring of intellectual property, Congress devised a complex system for taxing "global intangible low-taxed income"—known by the acronym GILTI.

Under the old tax laws, U.S. companies with significant intellectual property often attempted to reduce their worldwide effective tax rate by housing IP in a subsidiary located in a low-tax jurisdiction. This subsidiary would then receive royalties or other similar income from related entities and third parties—in substance, shifting profits from the United States to the jurisdiction with the lower tax rate (e.g., Ireland, with a general corporate tax rate of 12.5%).

In creating the new GILTI tax, Congress faced a difficult problem—how to impose U.S. tax on a foreign subsidiary’s income from intangible assets that had been shifted out of the U.S. tax base. Clearly not all income and expenses of a non-U.S. subsidiary should be subject to the extraterritorial reach of the U.S. tax net. The subsidiary might well have thousands of employees, and not all of the income should be attributed to intellectual property shifted out of the U.S.

How it Works

To achieve rough justice, the GILTI regime uses an estimate that, in practice, may have little to do with IP or income-shifting.

Essentially, the GILTI rules create an arbitrary line intended to serve as an approximate distinction between income from a subsidiary’s tangible assets and income from the subsidiary's intangible assets, without determining whether any IP has in fact been shifted out of the U.S.

The GILTI regime does this through a foreign subsidiary, which calculates its total tax basis in depreciable tangible assets, while ignoring intangible assets. An annual amount equal to 10% of the subsidiary’s total tax basis in tangible assets is deemed to be non-shifted income and is not subject to U.S. tax. Anything above that return threshold is deemed to be income from shifted IP, therefore subjecting it to GILTI tax, with the potential availability of limited foreign tax credits. The tax applies to the U.S. parent, not the foreign subsidiary.

Example

Suppose a foreign subsidiary manufactures plain black umbrellas. If the subsidiary's tax basis in its depreciable tangible assets is $2 million, then it can earn up to US$200,000 annually exempt from GILTI tax. That is, US$200,000 equals 10% of its tax basis in depreciable tangible assets.

What about an umbrella manufacturer with the good fortune to earn far more than a 10% deemed return? Suppose, for example, the same umbrella manufacturer's annual net income is US$300,000.

Under the GILTI rules, the additional US$100,000 is deemed to be net income from intangible assets. The GILTI rules essentially deem the additional income as being from intangibles.

As a result, the umbrella subsidiary's U.S. corporate parent owes a GILTI tax equal to 10.5% of its US$100,000 of bad income—a tax of US$10,500. In 2026, the tax rate increases to 13.25%, subject in both cases to the use of limited foreign tax credits. Foreign tax credits can therefore provide a form of tax exemption from GILTI for subsidiaries operating in a high tax jurisdiction.

U.S. Companies Doing Business in Canada Through a Subsidiary

On the one hand, subsidiaries with few tangible assets could create a GILTI tax risk. Service-oriented businesses, for example, could be especially vulnerable. Businesses whose value is attributable to IP or sales would be vulnerable to incurring a GILTI tax, as would businesses with a high rate of return relative to their tangible asset base.

On the other hand, U.S. acquirors may be motivated to seek out Canadian targets with significant tangible assets (e.g., natural resources and infrastructure). The U.S. appetite for such Canadian assets would be bolstered by other favourable changes instituted by U.S. tax reform—such as the reduced U.S. federal corporate income tax rate of 21%, the availability of accelerated depreciation for newly acquired assets, and the new participation exemption allowing the repatriation of foreign profits tax-free.

While the broad outlines of the GILTI regime are known, the U.S. tax authorities have so far avoided many difficult questions posed by the new rules. It remains to be seen whether the GILTI regime and other recent U.S. tax reforms will effect a dramatic reshaping of cross-border business.