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gross income (excluding effectively connected income, high-taxed amounts, related-party dividends, and foreign oil and gas income) reduced by deductions allocable to such income. CFCs' tested income and loss are netted at the U.S. shareholder level. Net deemed tangible income return is the excess of 10 percent of the aggregate of the U.S. shareholder's CFCs' qualified business asset investment (QBAI) over the amount of interest expense, whose corresponding interest income is not included in net CFC tested income (tangible income return is reduced by interest paid to a third party, but not if paid to another of the shareholder's CFCs). QBAI is the adjusted basis in depreciable tangible property used in a trade or business.[3]

The U.S. shareholder is permitted a partial foreign tax credit equal to 80 percent of the "inclusion percentage," equal to the shareholder's aggregate GILTI divided by the shareholder's share of the CFCs' tested income, times aggregate tested foreign income taxes paid or accrued by all CFCs properly attributable to tested income.[4] The section 78 gross-up is 100 percent of the amount of foreign tax that is eligible for the 50 percent GILTI deduction. A separate basket is created for GILTI deemed-paid credits, which cannot be credited against other U.S. taxes on FSI. No carryback or carryforward on excess GILTI credits is permitted. An illustration of the GILTI calculation is shown in Example 1 of the Appendix.

B. FDII

The FDII provision is the conceptual inverse of the GILTI tax. A U.S. corporation receives a 37.5 percent deduction[5] on its FDII, which is the corporation's deemed intangible income (DII) multiplied by the ratio of its foreign-derived deduction eligible income (foreign-derived DEI) over its DEI. DII (compare with the GILTI amount) is the excess of DEI over deemed tangible income return (10 percent of QBAI). DEI is the excess of gross income (excluding subpart F, GILTI, financial services income, dividends from CFCs, and foreign branch income) over allocable deductions, and foreign-derived DEI is that portion of DEI derived in connection with the sale of property or the provision of services to a foreign person.

Special rules disqualify sales and services provided to related foreign persons from being considered foreign-derived DEI unless the products or services are ultimately used by an unrelated foreign person. If the sum of FDII and GILTI amounts exceed taxable income, section 250 proportionally reduces FDII and GILTI amounts so that their sum equals taxable income.

C. A Note on GILTI and FDII

A quick aside to challenge some mistaken impressions that have sprung up around GILTI and FDII. First, despite containing intangible income in their names, both provisions apply broadly to a wide range of taxpayers: GILTI applies to any U.S. shareholder of a CFC (not just limited to corporations), and FDII applies to any U.S. corporation that sells abroad. Even companies outside the technology or pharmaceutical sectors, which might not think of themselves as having significant offshore intangibles, could have significant GILTI inclusions and must incorporate GILTI and FDII into their tax calculations.

Second, using the effective foreign tax rate (either on a CFC-by-CFC basis or aggregated at the U.S. shareholder level) as a rule of thumb to estimate whether a taxpayer is subject to GILTI may result in an incorrect answer because of expense allocation under reg. section 1.861-8. The conference committee's Joint Explanatory Statement notes:

> Under a 21-percent corporate tax rate, and as a result of the deduction for FDII and GILTI, the effective tax rate on FDII is 13.125 percent and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5 percent for taxable years beginning after December 31, 2017, and before January 1, 2026. Since only a portion (80 percent) of FTCs are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at

[3] The definition of "specified tangible property" in section 951A(d)(2)(A) as "tangible property used in the production of tested income" seems to exclude tangible property of CFCs with tested losses from QBAI, but this issue is unclear.

[4] Tested foreign income taxes do not appear to include foreign income tax paid by any CFC with a tested loss.

[5] Like GILTI, the deduction is reduced to 21.875 percent in years beginning after December 31, 2025.

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which no U.S. residual tax is owed by a domestic corporation is 13.125 percent.[6]

Based on this language, a taxpayer whose CFCs are all in countries with effective foreign corporate tax rates well above 13.125 percent might conclude that there will be no GILTI exposure. Likewise, a taxpayer with CFCs in a mix of high- and low-tax jurisdictions (Germany and Ireland, for example) but whose foreign income is taxed at an overall rate exceeding 13.125 percent might believe GILTI does not apply because the GILTI amount is determined at the U.S. shareholder level.

However, newly added section 904(b)(5) implies that GILTI is potentially a "class of income" to which expense allocation rules apply. Allocating interest expense to GILTI, for example, limits the FTCs that are available to offset the GILTI inclusion. Because there is no carryback or carryforward of excess GILTI credits, there may always be a GILTI inclusion from a CFC in a country with a tax rate exceeding 13.125 percent. For the same reason, timing differences in the recognition of income and expense items under U.S. and foreign tax law may also create GILTI inclusions from relatively high-taxed countries. See Example 2 of the Appendix for an illustration.

While Congress's intent may have been to tax GILTI only to the extent that the foreign tax rate is lower than 13.125 percent (for tax years up to December 31, 2025), without modification to either the current section 904 or reg. section 1.861-8, in our view, a GILTI tax exists if U.S. expenses are allocated or apportioned to GILTI income. We will need to wait to see whether Treasury issues guidance to address this issue.

D. BEAT

Section 59A imposes a minimum tax of 10 percent[7] on large corporations[8] with a base erosion percentage of 3 percent or greater.[9] The corporation must pay a base erosion minimum tax amount, which is 10 percent[10] of modified taxable income (MTI) over the regular tax liability. Calculation of MTI starts with regular taxable income, with base erosion tax benefits and the base erosion percentage of any applied net operating loss added back. Base erosion tax benefits are amounts paid or accrued to a foreign related party,[11] including amounts includible in the basis of a depreciable or amortizable asset. Payments included in cost of goods sold for services accounted for under the services cost method, for qualified derivatives, or subject to withholding under sections 1441 or 1442, are not base erosion tax benefits. The base erosion percentage is the total base erosion tax benefits divided by the deductions allowable to the taxpayer for the year (excluding NOLs, participation exemptions, and the section 250 deduction for GILTI and FDII).

The regular tax liability is determined after reduction by any credits, except for the research and development credit and a portion of the section 38 general business credits (GBC).[12] The BEAT stacks with the interest limitations under new section 163(j) so that any disallowed interest is treated as paid entirely to unrelated parties. The remaining related-party payments are then considered base erosion tax benefits and increase the BEAT.

II. Considerations for Q1 Interim Reporting

In our conversations with clients, they understand the need to incorporate GILTI, FDII, and BEAT into their 2018 year-end tax provisions. However, because of the hectic activity surrounding the 2017 year-end close and the calculation of the section 965 toll tax, many have not begun incorporating those provisions into

[6] Joint Explanatory Statement of the Committee of Conference, H.R. Rep. No. 115-466 (Dec. 15, 2017), at n.1526.

[7] 5 percent for 2018.

[8] Applicable taxpayers are corporations (excluding regulated investment companies, real estate investment trusts, and S corporations) that are part of a group that has an average of $500 million in gross receipts over the previous three tax years. The group includes all persons treated as a single employer under section 53(a) (*i.e.*, within a 50 percent controlled group of corporations), disregarding the exception for foreign corporations under section 1563(b)(2)(C). For foreign corporations, only gross receipts from ECI are taken into account.

[9] 2 percent for banks and securities dealers.

[10] 5 percent for 2018, rising to 12.5 percent for tax years beginning after December 31, 2025. All rates are 1 percentage point higher for banks and securities dealers.

[11] 25 percent foreign shareholder as defined in section 6038A, related person under section 267(b) or section 707(b)(1), or related under rules of section 482.

[12] GBC are allowed up to the lesser of 80 percent of the total section 38 credits amount or the base erosion minimum tax amount. For tax years beginning after December 31, 2025, the regular tax is reduced by all credits (including GBC).

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their annual effective tax rate (ETR) calculations for first-quarter interim reporting under ASC 740-270 (formerly APB 28). Fortunately, after discussion at the January 10 meeting of the Financial Accounting Standards Board, the FASB staff has issued a series of Staff Q&A documents on its tax reform implementation page that provide guidance on accounting for BEAT and GILTI.[13]

A. BEAT

According to the FASB staff's analysis, the incremental effect of BEAT should be recognized as a cost in the period the BEAT is incurred, with deferred tax assets and liabilities measured at the 21 percent statutory rate. This is analogous to the accounting for the corporate alternative minimum tax (AMT, repealed in TCJA), where the AMT is treated as a parallel tax system under which taxpayers can never pay less (and may sometimes pay more) than their regular tax liability. Measuring a deferred tax liability at a lower, "minimum" rate would have the counterintuitive result of lowering the taxpayer's reported tax expense.[14] The same logic holds for the BEAT. Accounting for the BEAT as a period cost also relieves companies of the difficult exercise of projecting when they will be subject to either the regular or the BEAT tax system to measure deferred taxes. The observation in ASC 740-10-30-11 that "no one can predict whether an entity will always be an alternative minimum tax taxpayer" applies doubly to the BEAT, which would require estimating the amount and character of payments to be made to foreign related parties years into the future.

One important difference between accounting for the AMT and the BEAT is the effect on the annual ETR calculation. Because the BEAT lacks the AMT's interaction with the regular tax system through a credit mechanism, temporary differences will be reflected in the incremental cost of the BEAT without an offsetting change in credits usable in later periods. Excluding the effect of permanent differences, the ETR then will always be equal to or greater than the 21 percent statutory rate.

B. GILTI and FDII

Accounting for GILTI poses the same issues around measurement of deferred taxes as accounting for BEAT. FASB, however, did not definitively settle the issue. Companies may treat GILTI similarly to other subpart F income. Just as deferred taxes should be recognized on basis differences that are expected to produce subpart F income when reversed, deferred taxes should be recognized on basis differences if there will be an effect on future GILTI tax amounts. On the other hand, the FASB recognized the view that the amount of GILTI inclusion depends on contingent events (future foreign income and loss, amount of foreign assets, and FTCs), and therefore the accounting for GILTI should follow the accounting for special deductions as a period cost. Further, because tested income and loss are netted across CFCs and aggregated at the U.S. shareholder level, basis differences at one CFC may be offset by basis differences at other CFCs. Treating GILTI as a period cost might provide a more accurate understanding of the true GILTI tax expense than recognizing deferred taxes on the basis differences for all of a taxpayer's CFCs individually.

The FASB holds that both views have merit and that companies may elect (with proper financial statement disclosure) either interpretation. However, once one treatment is selected, changing the accounting for GILTI should be considered a change in accounting policy per ASC 250-10-45-2. We anticipate, given the complexity of projecting the GILTI rate and scheduling deferred taxes, that many companies will choose to account for GILTI as a period cost.

FDII should be treated as a special deduction (similar to section 199) under ASC 740-10-25-37. The deduction on FDII requires future performance of specific activities (that is, making foreign sales), just as section 199 depends on the performance of qualified production activities and the amount of wages paid.

[13] Financial Accounting Standards Board, "Accounting for the Tax Cuts and Jobs Act."

[14] ASC 740-10-30-11 ("It would be counterintuitive if the addition of alternative minimum tax provisions to the tax law were to have the effect of reducing the amount of an entity's income tax expense for financial reporting, given that the provisions of alternative minimum tax may be either neutral or adverse but never beneficial to an entity.").

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III. Estimating GILTI, FDII, and BEAT Rates

APB 28 requires that companies estimate their annual ETR, including the effect of GILTI, FDII, and BEAT, for the purposes of recording the tax expense accrued in each quarter. While accounting for GILTI and BEAT as period costs does simplify the calculation, companies will need to incorporate more detailed estimates of their international activities into their quarterly tax provision process.

Estimating GILTI begins with a projection for the year of worldwide income and expense on a country-by-country level (if not CFC-by-CFC level, depending on final regulations regarding FTCs and QBAI of tested loss entities). As this projection is updated over the course of 2018, the GILTI ETR effect may shift significantly. Companies will also need an up-to-date register of foreign tangible assets held by CFCs. Consider that, with the repeal of the section 958(b)(4) prohibition on "downward attribution" of stock owned by a foreign parent to its U.S. subsidiary, many domestic entities may have new CFCs by constructive attribution and will have to consider GILTI inclusions from those new CFCs.

Estimating FDII should be relatively easy because the calculation depends on U.S. foreign income (in aggregate) and domestic tangible asset base, all of which most companies track already. One potential wrinkle is the limitation under section 250 of the sum of FDII and GILTI deductions to taxable income, which would reduce the allowable FDII deduction and raise ETR (because there is no carryforward of excess deductions).

For the BEAT, companies (if they are part of a group meeting the gross receipts threshold) will have to project their payments to foreign related persons (base erosion tax benefits) to first determine whether they exceed the 3 percent base erosion percentage threshold, and then to estimate the amount of additional tax. While we await further guidance on the required detail in disclosures around BEAT, we anticipate that a detailed assessment of the sources and uses of cash for the foreign shareholder and U.S. corporation will be required to estimate the amount of base erosion payments that will be made throughout the year.

IV. Appendix: GILTI Illustrations

A. Example 1: Full GILTI Calculation With Loss CFCs

The United States owns 100 percent of FS1 and FS2, which are CFCs. In this example, FS1 has tested income, and FS2 has a tested loss.

Because FS2 has a tested loss, its tangible assets are not included in the United States' aggregate QBAI, and foreign taxes paid by FS2 are not properly attributable to tested income.

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Table 1

	FS1	FS2	U.S.
Tested income (loss)	$900	-$10	$890
Tangible property	$150	$4,000	
QBAI	$150	—	
10 percent of aggregate QBAI	$15	—	$15
Interest expense included in net tested income	$5	$5	$10
Net deemed tangible income			$5
GILTI			$885
Foreign taxes paid	$100	$25	
Foreign taxes attributable to tested income	$100	—	$100
Inclusion percentage			99%
Deemed paid credit after 20 percent haircut			$79.6
GILTI with section 78 gross-up			$985
Taxable income after 50 percent deduction			$492.5
Expense allocated to GILTI			$75
GILTI amount for FTC limitation			$417.5
FTC limitation			$87.7
U.S. tax			$103.4
FTC used			$79.6
Remaining U.S. tax on GILTI			$23.9

B. Example 2: Interest Allocation

The United States owns 100 percent of FS1, a CFC. FS1 is located in a foreign country with a statutory tax rate of 15 percent. For simplicity, FS1 has no QBAI.

Note that, even though FS1 has a foreign effective tax rate above 13.125 percent, allocating expense to the GILTI income basket results in a FTC limitation, resulting in U.S. residual tax.

Table 2

		U.S.	
	FS1	With Expense Allocation	Without Expense Allocation
GILTI	$85	$85	$85
Foreign taxes attributable to tested income	$15	$15	$15
Deemed paid credit after 20 percent haircut		$12	$12
GILTI with section 78 gross-up		$100	$100
Taxable income before allocated expenses and FTC		$50	$50

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Table 2 ***(Continued)***

	FS1	U.S.	
		With Expense Allocation	**Without Expense Allocation**
Expense allocated to GILTI		—	$10
GILTI amount for FTC limitation		$50	$40
FTC limitation		$10.5	$8.4
U.S. tax		$10.5	$10.5
FTC used		$10.5	$8.4
Remaining U.S. Tax on GILTI		—	$2.1

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