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GILTI as (Dis)charged: Modifications and discharges of debt issued by CFCs can cause income inclusions for US shareholders under Tax Reform

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Prior to the effectiveness of the global intangible low-taxed income ("GILTI") provisions of the "Tax Cuts and Jobs Act" (the "Act"), modifying or restructuring the debt of a controlled foreign corporation (a "CFC")[1] often had relatively limited US tax effects on the CFC and its US Shareholders.[2] Any cancellation of indebtedness income ("CODI") incurred for US federal income tax purposes by a CFC generally was not considered to be subpart F income[3] and often was not considered to be US-source income.

CFC debt modifications and restructurings have added US tax relevance under the new GILTI regime, which requires every US Shareholder of a CFC to include in gross income its GILTI for the taxable year.[4] GILTI is essentially (subject to certain exceptions) the excess of the US Shareholder's share of the CFC's net income (not limited to intangible income) over a deemed 10% return on the CFC's adjusted basis in tangible depreciable property used in a trade or business (less allocable interest expense). Corporate US Shareholders (but not individuals) are eligible to claim a deduction equal to 50% of their GILTI and foreign tax credits for 80% of foreign taxes paid on GILTI.

CODI earned by a CFC from a debt modification or restructuring generally will increase the CFC's net income, and any resulting GILTI will be included in gross income of US Shareholders. Furthermore, CODI arising from a "significant modification" (discussed below) often will not be taxable under local law; thus, foreign tax credits may not be available to offset the GILTI inclusion (and local tax advisors may not be sensitive to the US tax consequences of the modification). If CODI is excluded from income because the CFC is insolvent, certain of its tax attributes will be reduced, and if the basis of tangible depreciable property is among the tax attributes so reduced, the GILTI of such CFC is likely to be larger in subsequent taxable years as the deemed 10% return on the CFC's tax basis in tangible depreciable property will be lower.

The potential for CODI in a distressed restructuring is apparent, but CODI can arise whenever a debt instrument is significantly modified for US federal income tax purposes. Such significant modifications can result from (among other modifications) changes in interest rate, the payment of consent fees, maturity extensions, and security package changes. If a debt instrument is significantly modified, the "old" pre-modification debt instrument is deemed to be retired in exchange for the issuance of the "new" modified debt instrument. The issuer will incur CODI to the extent the adjusted issue price (as determined for US federal income tax purposes) of the old debt instrument exceeds the issue price (as determined for US federal income tax purposes) of the new debt instrument. CODI most commonly arises when the trading price of the debt instrument is below par.

In light of the new GILTI regime, it is now even more important to consider the US tax consequences of modifying or restructuring the debt of a CFC in consultation with a US tax advisor.

ENDNOTES

[1] A “CFC” is a foreign corporation over 50% of the stock of which, measured by vote or value, is owned by US Shareholders directly, indirectly or by attribution. The scope of the applicable attribution rules was expanded by the Act with the effect that many more foreign corporations will be treated as CFCs.

[2] A “US Shareholder” is any United States person that owns, directly, indirectly or by attribution, at least 10% of a foreign corporation’s stock (measured by vote or value).

[3] “Subpart F income” of a CFC consists of certain categories of passive and mobile income and generally is includible in gross income of the CFC’s US Shareholders on a current basis.

[4] GILTI income or loss is computed for each CFC with respect to a specific US Shareholder, and such amounts are netted for purposes of computing such US Shareholder’s GILTI inclusion. However, a US Shareholder would not benefit from a net GILTI loss from its CFCs.

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