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Treasury's High Wire Act – Final and Proposed Regulations on CFC High-Tax Exceptions

The Treasury, on July 23, 2020, issued final regulations (T.D. 9902) providing for a high-tax exclusion under the global intangible low-taxed income (GILTI) regime of Section 951A (GILTI HTE). The GILTI HTE generally allows U.S. shareholders of a controlled foreign corporation (CFC) to exclude from tested income amounts subject to foreign income tax of more than 18.9%, based on current U.S. corporate tax rates. At the same time, the Treasury released proposed regulations (REG-127732-19) modifying the Subpart F high-tax exception (Subpart F HTE) to conform to the now-finalized GILTI HTE. Despite the GILTI HTE's being made available annually and retroactively, the 2020 Final Regulations render the exception's application much more complex and potentially less beneficial than the 2019 proposed rules—especially in conjunction with other Code provisions. The 2020 Proposed Regulations would also diminish the utility of the Subpart F HTE relative to current rules.

Background

In general, U.S. shareholders that own 10% or more of a CFC are subject to income inclusions under the Subpart F rules. The Subpart F rules are intended to tax currently certain income such as passive income of a CFC. Section 954(b)(4) excludes insurance and foreign base company income subject to foreign income tax greater than 90% of the maximum U.S. corporate tax rate—i.e., 18.9% based on the current 21% rate—from Subpart F income. Under current regulations, the Subpart F HTE is applied on an income-item-by-income-item basis.

The GILTI regime, enacted as part of the Tax Cuts and Jobs Act, requires U.S. shareholders of CFCs to include their share of GILTI in gross income each year. The idea behind GILTI was that U.S. shareholders should pay some U.S. tax on low-taxed or untaxed CFC income not caught by Subpart F. Commenters seized on legislative history indicating that U.S. shareholders ought not to incur residual GILTI tax if the effective foreign tax rate exceeded 13.125% (taking into account the 50% GILTI deduction and 80% foreign tax credit). In practice, however, the collateral impact of expense allocations on the Section 904 foreign tax credit limitation meant that GILTI tax could reach income subject to higher foreign tax rates. And Section 951A's only explicit foreign tax-based exclusion is for income eligible for the Subpart F HTE of Section 954(b)(4), which has been Treasury's point of departure for the GILTI HTE.

Regulations proposed in 2019 would have allowed an elective GILTI HTE to exclude from tested income any income subject to the same foreign tax threshold as the Subpart F HTE, even income other than insurance or foreign base company income—in contrast to the narrow application of the HTE only to these types of income in simultaneously issued final regulations. Eligibility for the GILTI HTE would have been determined for each "qualified business unit" (QBU) of a CFC to curtail blending low- and high-taxed income. The election would have been revocable, with a 60-month waiting period to make a new election.

The 2019 Proposed Regulations also provided rules on the treatment of U.S. partnerships under Subpart F and the consolidated return rules, but Treasury has indicated they will finalize those rules separately.

Final GILTI Regulations

The 2020 Final Regulations maintain the general structure of the 2019 Proposed Regulations, but with several important changes. Instead of the QBU-by-QBU method of the proposed rules, the 2020 Final Regulations apply the GILTI HTE on a "tested unit" basis. Tested units include (1) a CFC; (2) a branch with a taxable presence in the country where it is located; (3) a branch without a taxable presence in the country where it is located but subject to an exemption or reduced tax in the branch owner's country of residence; (4) a pass-through entity, including a disregarded entity, that is tax resident in a foreign country; and (5) a pass-through entity treated as a corporation by its owner's home country. Per a mandatory "tested unit combination rule," tested units of a CFC that are resident or have a taxable presence in the same country are combined to determine the relevant foreign tax rate. This rule purports to simplify GILTI HTE determinations and to permit more blending than under the 2019 Proposed Regulations.

A CFC's gross income is allocated to tested units to the extent properly reflected on the separate books and records of the tested unit (or to the extent it would be so reflected if such records were maintained). Disregarded payments from or among branches or disregarded entities are generally regarded for this purpose. Deductions and foreign taxes are allocated to tested units, generally following the foreign tax credit limitation rules of Section 904 and deemed paid foreign tax rules of Section 960.

The GILTI HTE is made by a CFC's "controlling domestic shareholder" or all U.S. shareholders if there is no controlling domestic shareholder. The preamble to the 2020 Final Regulations provides that a domestic partnership may be treated as a controlling domestic shareholder for purposes of making the election, based on currently applicable Subpart F regulations proposed in 2019. Under a consistency rule retained from the 2019 Proposed Regulations, the GILTI HTE must be applied to all income of all CFCs in a controlling domestic shareholder group (a "CFC group") or to none of them. A CFC group generally means an affiliated group within the meaning of Section 1504(a), but with modifications that broaden the definition.

Fortunately, the 2020 Final Regulations adopt the 2019 Proposed Regulations' expansive application of the GILTI HTE to income other than insurance and foreign base company income. The 2020 Final Regulations also helpfully eliminate the proposed 60-month restriction on new GILTI HTE elections after revocation of a prior election. Now taxpayers can decide annually whether or not to make the election. Although the 2020 Final Regulations are generally prospective, taxpayers can apply the GILTI HTE retroactively to tax years of CFCs beginning in 2018, so long as the final rules are consistently followed.

Proposed Subpart F Regulations

Comments to the 2019 Proposed Regulations had generally requested that the proposed GILTI HTE operate similarly to the more favorable Subpart F HTE under current regulations. Alas, the 2020 Proposed Regulations take the opposite tack, conforming the Subpart F HTE to the finalized GILTI HTE, including applying the Subpart F HTE on a tested income basis (rather than to separate income items). Indeed, Treasury proposes to adopt a single, or “unified,” HTE election for both Subpart F and GILTI, modeled on the 2020 Final Regulations. As a result, an electing taxpayer would have to apply the HTE for both GILTI and Subpart F or for neither, extending the consistency rule retained from the 2019 Proposed Regulations.

The 2020 Proposed Regulations would also import the final rules’ tested unit combination rule. But unlike the 2020 Final Regulations, the 2020 Proposed Regulations would offer a de minimis rule that requires tested units attributed less than a certain amount of gross income to be further combined (even if the tested units are not in the same country). The proposed rules would also apply the Subpart F HTE without regard to the current earnings and profits (E&P) limitation on Subpart F income in Section 952(c)(1). To prevent manipulation of the unified HTE, the 2020 Proposed Regulations contain various anti-abuse rules concerning the de minimis combination rule, disregarded payments, and certain instruments and hybrid entities.

Neither current Subpart F HTE regulations nor the 2020 Final Regulations specify how U.S. shareholders of CFCs should substantiate amounts excluded under the Subpart F HTE or GILTI HTE (though one would hope taxpayers have maintained supporting records and calculations). The 2020 Proposed Regulations would mandate contemporaneous documentation and expand Form 5471 reporting to require HTE information.

Except for Prop Reg. Section 1.954-1(f)(4), concerning carryover of recapture amounts in Section 381(a) transactions, the 2020 Proposed Regulations would apply prospectively to tax years of CFCs beginning on or after the date the rules are finalized.

Conclusion

Broadly speaking, the 2020 Final Regulations aim to allow a corporate U.S. shareholder of CFCs to avoid residual GILTI tax due to expense apportionment, so long as the CFCs’ effective foreign tax rate exceeds 18.9%. But the potential side effects of making the election—or not—could be precarious. The GILTI HTE restricts taxpayers’ ability to cross-credit high foreign taxes within a CFC group to avoid residual liability. The election could also adversely affect the Section 163(j) interest deduction limitation (due to the exclusion of high-tax income in computing the 30% limitation) and application of Section 267A to hybrid instruments or entities. In addition, amounts excluded from tested income pursuant to the election would have to qualify for the dividend-received deduction of Section 245A to be tax-free, and such dividends are ineligible for foreign tax credits. On the upside, a taxpayer’s base erosion anti-abuse tax (BEAT) exposure could be mitigated by making the election, as a result of a smaller (if any) GILTI inclusion in modified taxable income and fewer foreign tax credits reducing regular tax liability in the BEAT calculus. Applying the GILTI HTE retroactively could also enhance the benefits under the CARES Act’s net operating loss (NOL) carryback provisions, since a lower GILTI inclusion could translate to a higher NOL available for carryback. Individual U.S. shareholders’ considerations, including possible interaction with a Section 962 election, are also quite involved.

If the 2020 Proposed Regulations are finalized, the unification of the GILTI HTE and Subpart F HTE will make the election decision even more of a balancing act.

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