The Proposed GILTI High Tax Exclusion

Taxpayer Favorable Proposed Regulations under Section 951A

July 1, 2019

U.S. Shareholders of controlled foreign corporations ("CFCs") should be aware that proposed regulations issued on June 14, 2019, could significantly alter how the new Global Intangible Low-Taxed Income ("GILTI") regime under new section 951A affects their tax bills. If finalized, the regulations would permit taxpayers to elect to exclude CFC income items subject to foreign income tax at rates exceeding ninety percent of the maximum U.S. corporate rate (currently 21%), or 18.9%.

The election effectively results in the elimination of U.S. taxation of the high-tax amounts for corporate U.S. Shareholders when paired with the new participation exemption. It would also permit individual U.S. Shareholders of CFCs to defer U.S. taxation of eligible high-tax amounts until repatriation notwithstanding that the "high-tax" threshold is set at roughly fifty percent of the current maximum U.S. individual rate (37%).

I. Background

The Tax Cut and Jobs Act of 2017 (the "TCJA") adopted a participation exemption system. Under new section 245A, domestic corporations may deduct 100% of the foreign-source portion of any dividend from a specified 10-percent owned foreign corporation. To guard against base erosion in light of this new participation exemption, the TCJA not only retained the subpart F regime, but also enacted the GILTI regime.

The GILTI regime requires a "U.S. Shareholder" of a CFC (generally, a U.S. person that is a 10% direct or indirect shareholder) to include the shareholder's global intangible low-taxed income, or GILTI, in gross income. A shareholder calculates its GILTI inclusion by aggregating the tested income and losses of its CFCs and subtracting its net deemed tangible income return, which equals ten-percent of its qualified business asset investment ("QBAI") in excess of certain allocated interest expense. Determination of a CFC's tested income begins with the CFC's gross income, but excludes certain categories of income, including gross income subject to the subpart F regime and gross income "excluded from" that regime "by reason of section 954(b)(4)," which provides that gross income items subject to an effective foreign tax rate greater than ninety percent of the maximum U.S. corporate rate are not includible in income under subpart F.

Following the TCJA's enactment, the scope of this carve-out for high-tax income became subject to much debate. One reading of the statute suggests that the carve-out only applies to income that would otherwise be subject to the subpart F regime but for the section 954 high-tax exception. A more expansive reading suggests that the carve-out applies to any high-taxed income even if that income would not otherwise be foreign base company income or insurance income. In a move that surprised many, and with heavy reliance on the legislative history of the TCJA, Treasury adopted the more expansive reading in a recently proposed regulation.

II. The Proposed Regulation

A. Making the Election

The proposed regulation permits elective exclusion of a CFC's high-tax income from gross tested income. The election generally applies on a CFC-by-CFC basis, which means the exclusion either applies to all of the CFC's high-tax income items or none. When certain common ownership and control thresholds are met, however, the election applies with respect to the group of commonly controlled CFCs instead.

The controlling domestic shareholder(s) of the CFC or group of CFCs makes the GILTI high-tax exclusion election by filing a statement in accordance with the regulations with their original or amended tax return for the U.S. Shareholder inclusion year in which or with which the CFC inclusion year ends. The election applies for each subsequent inclusion year unless and until revoked. The controlling domestic shareholder may revoke an initial election at any time without permission from the Secretary; however, subsequent elections and revocations are effective for no less than a 60-month period unless a change in control occurs.

B. Determining which Income is Excluded

For purposes of determining whether income is subject to "high tax" and therefore excludible, all gross income items attributable to a single qualified business unit ("QBU") of the CFC are aggregated for purposes of the effective rate test. Deductions are allocated and apportioned to each QBU's gross tested income, and the effective rate of foreign tax on each is then calculated. If the item's effective rate exceeds 90% of the maximum corporate rate, it will be excluded if an effective election is in place.

C. Knock-on Effects of the Election

Taxpayers do not receive a section 960 deemed paid credit for any foreign income taxes allocated and apportioned to an item of income excluded under the high-tax exclusion. Additionally, taxpayers may not treat any property used to produce excluded income as QBAI, which has the effect of diminishing the CFC's deemed tangible income return, an amount not subject to GILTI.

D. Effective Date

The GILTI high-tax exclusion would apply to taxable years of foreign corporations beginning on or after the date of publication in the Federal Register of Treasury's decision to adopt the rules as final. Treasury has, however, signaled that it will consider making the final rule retroactive to January 1, 2018, when the GILTI regime took effect.

E. Analysis Necessary

Should these regulations be finalized, controlling domestic shareholders of CFCs will need to consider various factors before making an election. In particular, because the election alters the availability of other benefits like the deemed paid credit and QBAI, its value will depend greatly on other tax characteristics of the CFC and the U.S. Shareholders as well as the relevant foreign tax rates. In addition, because the election binds all U.S. Shareholders of the CFC, an election might be beneficial to one U.S. Shareholder but detrimental to another.

III. Regulatory Authority and Opportunity to Comment

The preamble to the proposed regulations asserts Treasury's authority to issue the regulations. While the strength of the arguments is subject to debate, future challenge of the rules appears unlikely given the elective and generally taxpayer-favorable nature of the exclusion.

The preamble to the proposed regulations includes several explicit requests for comments on the manner and terms of the election. Treasury remains open to discussion about fundamental characteristics of the election, including whether taxpayers should be allowed to make the election on an item-by-item basis or CFC-by-CFC basis rather than on a QBU-by-QBU basis and whether items of multiple CFCs in a single foreign country should be combined for purposes of the effective rate test. Consequently, the final regulations may vary in significant ways from the proposed regulations.

Although the rules are inapplicable currently, given this call for comments, U.S. shareholders of CFCs should contact their tax advisors sooner rather than later to take advantage of the opportunity to meaningfully, and advantageously, contribute to the development of the final rules.

Attorneys in Caplin & Drysdale's International Tax practice group are available to discuss these proposed regulations and to analyze their potential benefit for particular U.S. Shareholders.

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